

FEDERAL CORPORATE
INCOME TAXES

E. E. ROSSMOORE

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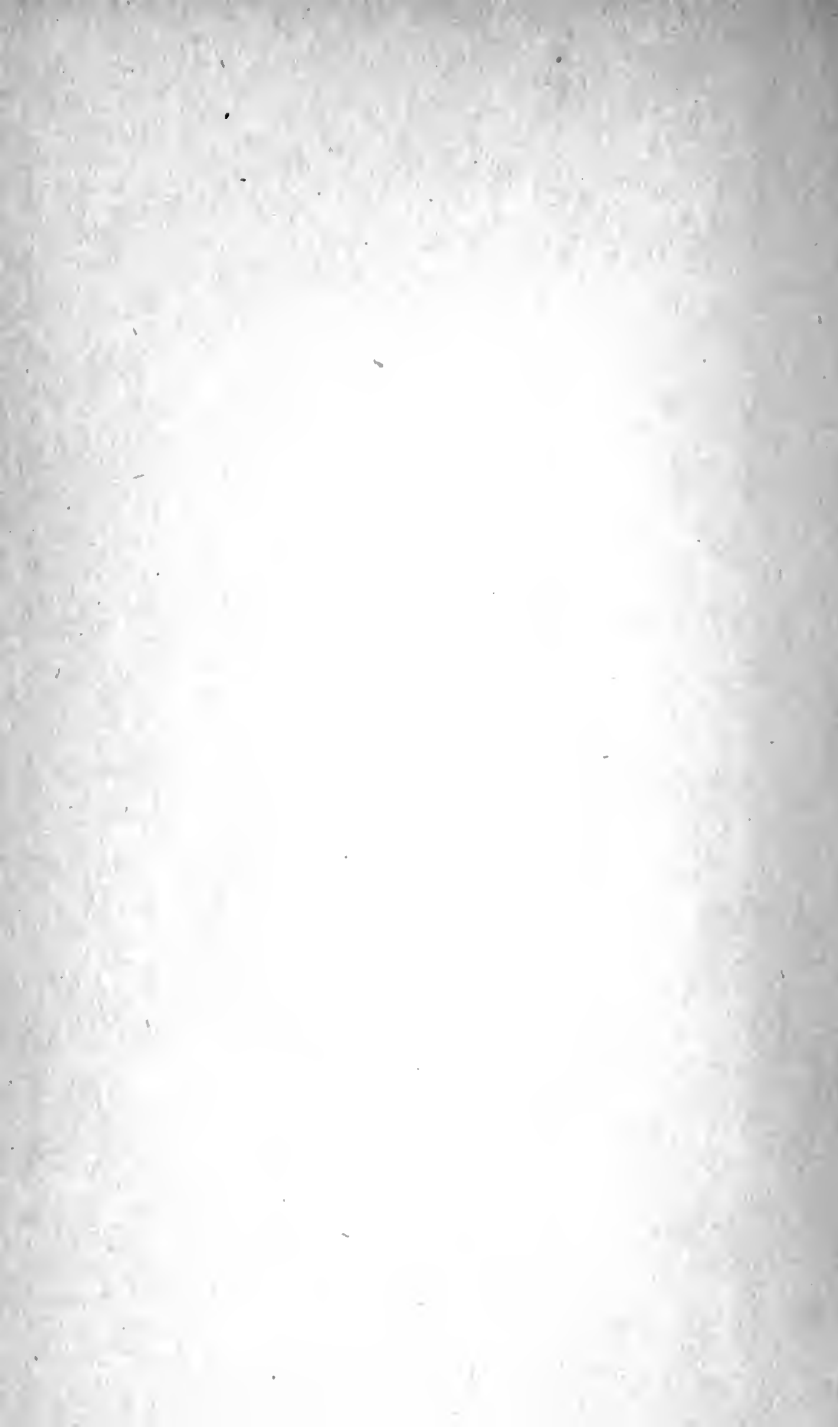
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FEDERAL CORPORATE INCOME TAXES



FEDERAL CORPORATE INCOME TAXES

BY

E. E. ROSSMOORE

B.S., C.P.A. (N.Y.)

FORMERLY:

CHIEF, SPECIAL AUDIT SECTION

CHIEF, CONSOLIDATED RETURNS SECTION

LECTURER ON INCOME AND PROFITS TAXES

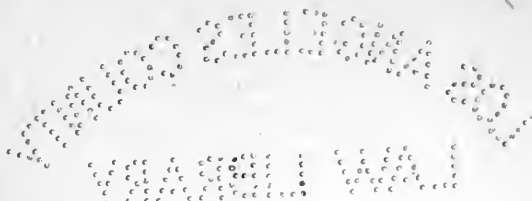
BUREAU OF INTERNAL REVENUE, WASHINGTON, D.C.



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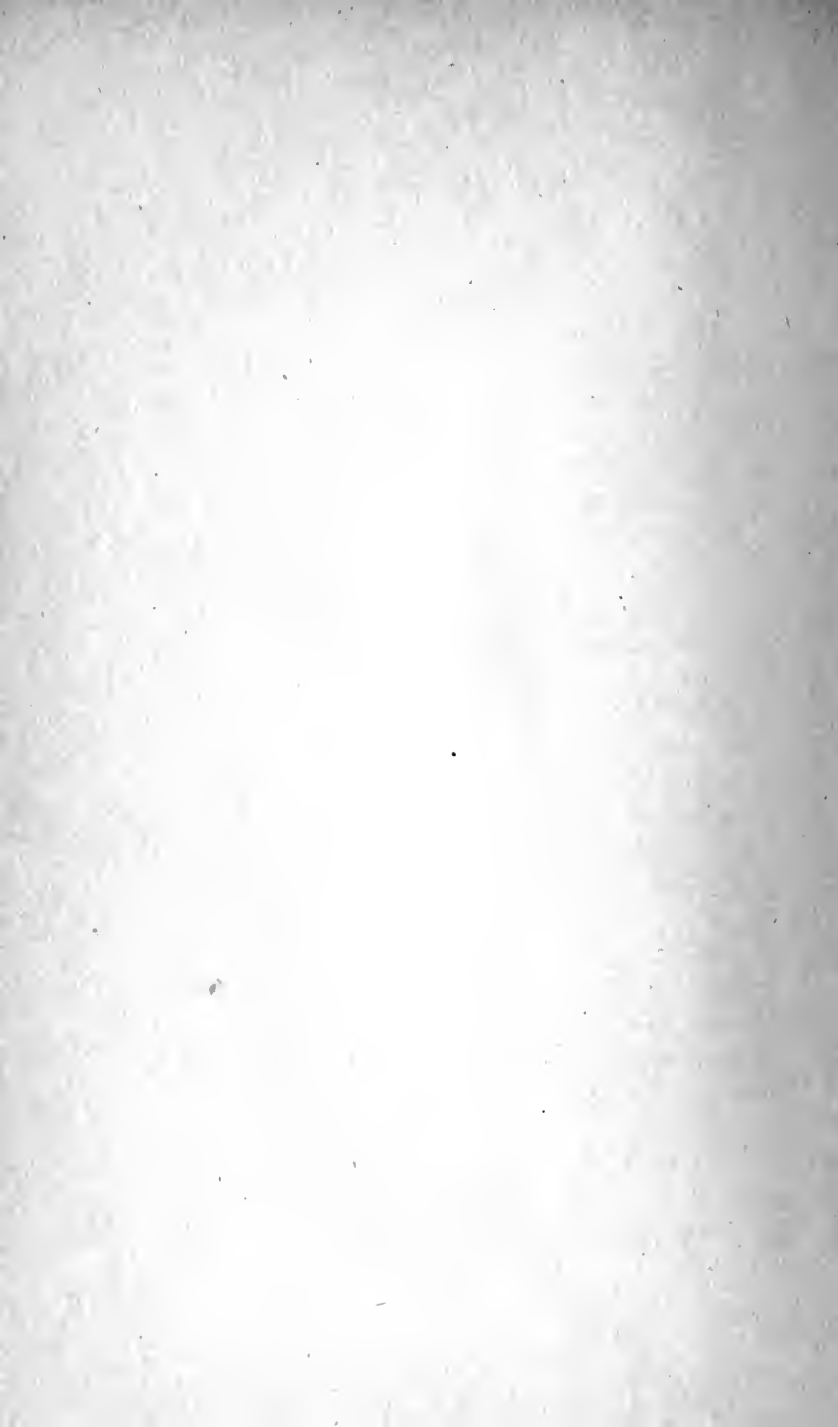
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DEDICATED TO MY FORMER FELLOW
WORKERS IN THE BUREAU OF
INTERNAL REVENUE

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PREFACE

THIS book, coming out at a time too late to be of material assistance to the taxpayer in the preparation of his Federal income and profits tax return for 1920, may appear to be out of place. However, the primary purpose of the book is to assist the taxpayer in his determination as to whether or not the computation of his tax liability under the several Revenue Acts has been correctly made and in accordance with the practice and procedure of the Bureau of Internal Revenue.

There has been considerable agitation on the part of taxpayers, particularly business people, for a repeal of the excess profits tax. The new administration is committed in its platform to such a repeal. However, the fact remains that the excess profits tax, despite its deficiencies, has been a source of great revenue to the Government and that the Government still needs and will need for many years to come very large revenues. Until a form of taxation has been agreed upon which can satisfactorily take the place of the excess profits tax, there will be no repeal of the latter. At the present time while the sales tax has been advocated by many men of prominence, it has by no means met with

PREFACE

the general approval of the public. It is possible that this year may see only an amendment to the excess profits tax law with a view to correcting certain defects and inequalities that exist. It is expected, however, that in the not very distant future, the excess profits tax will be repealed. It is a special tax enacted for special purposes under the stress of war conditions. If history is to repeat itself, the stress of war conditions being removed, special legislation arising out of war conditions should be repealed.

Prior to 1917, the Federal Income Tax laws were comparatively simple, both in their administrative features and their technical requirements. In the case of corporations the low rate of tax on net income, 1 per cent from 1909 to 1915 inclusive and 2 per cent for 1916, was such a small factor in the total cost of carrying on a business that very little attention was paid by the average concern to the question of income tax.

Due to the enactment of the Revenue Acts of 1917 and 1918, however, the question of Federal Income Taxes has become of prime importance in the business world, so much so that before closing transactions such as the sale of property, organization, dissolution, reorganization or merger of large corporations, etc., it is essential that the income and excess profits taxes be taken into consideration in

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determining upon what terms or conditions it would be advisable to enter into such transactions.

Transactions which took place during the taxable years 1917, 1918 and 1919 are now under review by the auditors of the Bureau of Internal Revenue and it has been found that the taxpayer conducting a business of any considerable size, who has prepared his returns in all respects in accordance with the regulations of the Treasury Department, is an exception. Upon the audit of returns filed in the past, most taxpayers, particularly corporations, are called upon by the Treasury Department to pay additional tax. The Bureau has commenced a huge drive to collect additional taxes which appear to be due by reason of the understatement of the tax liability in the returns which have already been made.

Commissioner Williams in his annual report states that, as the result of the work of the Income Tax Unit, additional taxes aggregating \$376,977,667.49 were assessed during the fiscal year ended June 30, 1920. He also states that with the prospective increase in personnel it is believed that the assessments to be made during the year 1921 may result in the collection of \$1,000,000,000 in additional taxes. Under these circumstances and because of the trying times through which business may have to go, it is imperative that the business man care-

PREFACE

fully scrutinize the tax returns which he has filed so that he may be prepared should the Treasury Department call upon him for additional tax.

It is recognized that, because of the hasty manner in which the Revenue Act of 1917 was drawn up, there has been doubt and confusion, both in the minds of the taxpaying public and in the minds of the Treasury Department officials, as to just what the requirements of the Act are.

Since the passage of the 1917 Revenue Act and the 1918 Revenue Act, the Bureau has had considerable opportunity to study these Acts, and as the result of such study has formulated and promulgated a host of regulations and decisions. While many of these decisions appear in the regulations and Treasury decisions which have been issued from time to time by the Treasury Department, yet there are many more of which the public has comparatively little knowledge.

It is to be understood that the decisions of the Bureau, although in many cases practically, have not actually the force of law. Such decisions represent the interpretation placed upon the law by the officials of the Bureau of Internal Revenue. From time to time the Bureau makes decisions which appear to be contradictory to others already made. Such decisions may or may not actually be contradictory to previous

PREFACE

decisions. The Bureau official responsible for the decision may have had a set of facts before him quite different from those in a case which appears to be a parallel one.

The author has tried to take important decisions of the Bureau and put them before the reader in such a way as to be readily comprehended without at the same time warping the viewpoint of the Bureau.

The purpose of this work is to present the author's interpretation, based upon his knowledge and experience, of the Bureau's views and regulations. The author will try to refrain from giving any expression as to his personal views of the decisions of the Bureau. He may or may not agree with them.

This book is not intended to treat fully or to cover the entire subject of Federal income and profits taxes. It is intended to supplement the regulations issued by the Treasury Department and the many works which have been written on the subject. The author has elaborated on those matters which are not fully covered in the regulations and concerning which he believes the public is not sufficiently informed. The problems given in Chapter VI have been prepared with a view to clarify and illustrate certain sections of the statutes and certain articles of the regulations.

The author wishes to acknowledge his indebtedness to his staff in the preparation of the

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manuscript. He also wishes to extend his thanks to those officials of the Bureau of Internal Revenue who have explained to him the recent changes in Bureau procedure.

E. E. ROSSMOORE.

NEW YORK, March, 1921.

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CHAPTER I

INTRODUCTORY

THE administration of the income tax laws in recent years has been a tremendous task. When the Revenue Act of 1917 was passed, no one ever dreamt of the gigantic undertaking which would result therefrom. The Bureau officials for the last few years deserve a great deal of commendation for the manner in which they have carried on their work. An idea of the size of the task may be gathered from the statistics covering merely the taxable year 1918. There were 3,883,189 returns filed for that year showing a tax amounting to \$4,339,185,288. The weight of the schedules alone for 1918 has been reported as being fifty-six tons. At the present time it is said that there are over fifty million returns and over thirty million pieces of correspondence relating to these returns in the files of the Income Tax Unit. It can be readily seen that in order to properly verify the correctness of such an enormous quantity of returns a fairly good-sized army of accountants is required.

Tremendous task of administration of tax laws.

The Bureau's first problem was therefore to gather together a working force properly qualified in accounting, engineering and business

Large personnel required.

FEDERAL CORPORATE INCOME TAXES

training so that it could quickly grasp the technical requirements of the tax laws. The personnel of the Bureau has increased from about three hundred in 1917 to the present personnel of over four thousand. It has had to absorb this number in a comparatively short time and has had to train its employees so that the administration of the tax laws would be fair and correct. When one considers the complexity of the income and excess profits taxes and the multitude of decisions which have been made, one readily realizes that such training is in itself a tremendous task. This work has been made more difficult by reason of the unduly large turnover of personnel.

Large turnover of personnel.

The Government has probably lost millions of dollars because of inability to retain in its employ people who have been trained to carry on this work effectively. Taxpayers have been greatly embarrassed because of the variety of people who have at different times examined their returns. The author hopes that Congress will have sufficient vision to take the proper steps to hold in the employ of the Bureau of Internal Revenue trained and qualified men and women. The Government should be prepared to meet in competition corporations and others who are ready to pay handsomely for the knowledge possessed by trained and experienced people in the Bureau. The Government should offer every inducement pos-

INTRODUCTORY

sible to retain in its employ its trained force. In that way it will render a considerable service not only to itself but to the taxpaying public, which is ready to meet its correct tax liability and eager for a prompt determination thereof.

The attitude of the administrative officers of the Bureau has been most considerate. The men selected to confer with taxpayers are the best available from the viewpoint of education, training and experience. The educational standard of the whole body of auditors is extremely high—at least seventy-five per cent of them are college graduates. The author has found the revenue agents and auditors of the Bureau of Internal Revenue to be absolutely fair, trying their best to do their duty to the Government and to the people.

Government desires to be fair.

Occasions have arisen, however, where agents of the Government have been overzealous in their duties with the result that the taxpayer has unjustly suffered. Taxpayers should remember that the Government does not want to deprive them of their last cent but desires to give them a square deal; however, it expects the full co-operation of the taxpayer. If the taxpayer will state his case frankly, he will find that the Government officials will be ready to extend him every consideration.

Government agents on rare occasions over-zealous.

The Bureau of Internal Revenue has made it a practice to instruct its field auditors to treat the taxpayer with the utmost courtesy and

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Full co-operation should be given Government representatives.

co-operate in every possible way so that an investigation may result in the determination of the correct tax due, regardless of whether it results in a refund or in an additional assessment.

It is unfortunate that occasionally examining officers and taxpayers attempt to take advantage of each other by methods which accomplish very little and create considerable bitterness sometimes leading to unpleasant consequences.

Every examining officer should have placed at his disposal all the available records and be given as much information regarding questions arising in connection with the audit as is possible. Occasionally, however, Government examiners do make impossible demands such as the furnishing of data within 24 hours which it may take the corporation several days to obtain. The corporation officials as well as the investigators should co-operate frankly without any attempt to delay the investigation or conceal information.

Much time and expense may be saved.

Many instances have occurred where much time and expense could have been saved if full details of various transactions had been disclosed at the original investigation. Before the completion of the investigation the taxpayer should make inquiry of the examiner regarding the estimated additional tax—if any; and if such tax is created by differences which

INTRODUCTORY

may be easily explained, the taxpayer should not spare time in furnishing the proper information to the Government's officer while he is still making his investigation. The taxpayer should not lose sight of the fact that every apparent discrepancy satisfactorily explained to the examiner on the ground may save costly trips to Washington. It is easier to eliminate misinterpretations of entries in the records while the examiner is in the taxpayer's office than it will be several months later after he has been working on other cases.

In case the revenue officer is not satisfied with the taxpayer's explanation and prepares an adverse report recommending additional assessment, the taxpayer should request the investigator to furnish him with a synopsis of the report of the audit which is to be forwarded to the Commissioner of Internal Revenue. If the report has not been completed the examiner should be requested to indicate the estimated additional tax and the nature of the adjustments contemplated.

Under ordinary circumstances it will take the authorities in Washington from two to three months to pass upon the revenue agent's findings and mail the taxpayer an A-2 letter, which is notice to the taxpayer of the proposed additional assessment as approved by the Bureau. These assessments are usually placed on the Collectors' lists in 30 to 40 days from the date

**Taxpayer
entitled to
statement
of findings
of investi-
gation.**

**A-2 letter
notification
of tax deter-
mination.**

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of the A-2 letter. So, if a taxpayer disagrees with any of the adjustments included in the A-2 letter, he should prepare a brief setting forth his objections and proof in support of his contentions which should be presented to the Bureau before the proposed tax is placed upon the Collector's list. In the case of large corporations it usually takes more than thirty days to furnish the necessary information to correct an additional assessment which happens to be erroneous. For this reason it is advantageous for the taxpayer to assemble without loss of time the data regarding the points in dispute to be submitted to the Commissioner in Washington immediately after the field investigation is completed, without waiting for the receipt of the A-2 letter.

Once an assessment is on the Collector's list the only remedy available is in the filing of a claim for abatement which may or may not be accepted by the Collector without the filing of a bond.

Abatement
claim rem-
edy when
assessment
made.

The filing of a claim for abatement in large cases is a costly affair. The Collector is personally liable for the assessments on his list, and for this reason he has absolute authority to accept or reject a claim for abatement without a bond.

If over-
payment,
refund or
credit
claim.

Whenever a taxpayer has erroneously overpaid his taxes a claim for refund or a claim for credit should be filed, preferably the latter,

INTRODUCTORY

especially when the taxpayer is sure of his ground.

The Commissioner has directed the efforts of the entire Income Tax Unit toward the closing of all 1917 cases before March 1, 1921. In some instances it will have been found impossible to complete all examinations. For this reason taxpayers are being requested to sign waivers so that any additional taxes due discovered after the expiration of the statutory limitation may be collected without litigation which is costly to both the Government and the taxpayer. The signing of a waiver does not deprive the taxpayer of the right of subsequently attempting to prove that a contemplated assessment is erroneous.

Waivers re
statutory
limitations
of assess-
ments.

CHAPTER II

PERTAINING TO OPERATIONS OF THE INCOME TAX UNIT

1. Organization of the Income Tax Unit—2. Mechanical Features of Handling Returns

I. Organization of the Income Tax Unit

Assessment
of Federal
taxes dele-
gated to
Commis-
sioner of
Internal
Revenue.

CONGRESS has conferred upon the Commissioner of Internal Revenue the right to determine and assess all excise, income, and profits taxes in accordance with the provisions of the several Revenue Acts covering the various taxable periods from 1909 to date.

The Commissioner of Internal Revenue has delegated his authority with respect to income taxes under the various Revenue Acts to four different groups:

Income
Tax Unit.

(1) The Deputy Commissioner of Internal Revenue, who is directly in charge of the Income Tax Unit which audits returns and determines the statutory tax to be assessed.

Solicitor of
Internal
Revenue.

(2) The Solicitor of Internal Revenue, who is in charge of the law department and decides all questions of a legal nature referred to him.

Committee
on Appeals
and Review.

(3) The Committee on Appeals and Review, who review cases of taxpayers upon appeal from the decision of the Income Tax Unit, and

OPERATIONS OF INCOME TAX UNIT

also pass upon matters referred to them by the Income Tax Unit.

(4) The Supervisor of Collectors, who is in charge of the 64 Collectors of Internal Revenue situated throughout the United States. The Supervisor of Collectors and the Collector of each district have nothing to do with the final determination of the tax liability of taxpayers but are charged merely with the responsibility of collecting all assessments of tax, penalties and interest. The Collectors are held personally liable for all assessments, so it is entirely within their discretion to accept or reject without a bond a claim for abatement or a claim for credit.

**Collectors
of Internal
Revenue.**

In the event the Income Tax Unit is undecided as to the proper interpretation of any of the provisions of the income tax acts with respect to any case under review, the question is referred by the Deputy Commissioner to the Committee on Appeals and Review, who prepare a decision or recommendation and if a legal point is involved the Committee refer their conclusions to the Solicitor of Internal Revenue, who co-operates with the Committee in arriving at a final decision.

**Income
Tax Unit
when in
doubt refers
matters to
Committee
on Appeals
and
Review.**

Conferences arranged before the Unit are handled by men who have had considerable experience in handling tax cases and are considered the best men available from each of the respective sections. The conferees are the "judges" of the lower court, their rulings are

**Conferees
meet tax-
payers or
their repre-
sentatives.**

FEDERAL CORPORATE INCOME TAXES

usually final as far as the particular section is concerned and the A-2 letter is adjusted in accordance with their decisions.

Appeal to
Committee
does not
stay assess-
ment.

An appeal to the Committee on Appeals and Review does not stay the assessment of additional tax, as it is listed as soon as the adjustments determined upon by the Unit have been made, provided the customary 30 days have elapsed.

After the Income Tax Unit has made its rulings and the taxpayer wishes to present additional facts, another conference should be arranged with the Income Tax Unit before submitting the case to the Committee on Appeals and Review, as the Committee will not consider any case on the basis of additional facts but only on the facts as presented before the Unit.

Appeal
from de-
cision of
Unit made
to Com-
mittee.

If a taxpayer has appealed from the decision of the Income Tax Unit to the Committee on Appeals and Review, the Committee requires the taxpayer to file a brief, setting forth the reason for his disagreement with the decision of the Income Tax Unit. At the time of filing the brief the taxpayer, if he so desires, may request an oral hearing before the Committee. In that event the Secretary of the Committee will notify the appellant of the exact date upon which such a hearing will be held.

The taxpayer will in due course be notified by the Income Tax Unit of whatever decision

OPERATIONS OF INCOME TAX UNIT

is reached by the Committee. Theoretically the taxpayer may refer the case to the Commissioner for a further hearing before him in the event that the Committee concur in the findings of the Income Tax Unit. However, from a practical standpoint the Committee represent the Commissioner and are his technical advisors, and as the Commissioner's duties are many and mostly administrative, he has very little time for the consideration of individual cases from a technical viewpoint. He, therefore, seldom overrules the decision of his Committee. The only recourse, therefore, left to the taxpayer in such a case is to bring the matter before the courts by instituting proceedings against the Collector of Internal Revenue of the district in which the disputed assessment was made.

The organization of the Income Tax Unit, which is directly under the supervision of the Deputy Commissioner, is divided into seven distinct Divisions, as follows:

Organiza-
tion of In-
come Tax
Unit.

- (1) Staff Division—IT: S
- (2) Administration Division—IT: AD
- (3) General Audit Division—IT: G
- (4) Field Audit Division—IT: F
- (5) Special Audit Division—IT: SA
- (6) Review Division—IT: R
- (7) Statistical Division—IT: ST

Each Division is supervised by the "Head of the Division" and the "Assistant Head."

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The Divisions are subdivided into "subdivisions" and "sections," and the subdivisions into sections. Each subdivision and section is supervised by a "Chief." Each division, subdivision and section has a designated symbol. For example: IT:G:P stands for Personal Returns Section of the General Audit Division of the Income Tax Unit. Thus IT means Income Tax Unit; G—General Audit Division, and P—Personal Returns Section. These symbols are placed at the top of each letter, showing the source from which the letter originated.

Staff Division.

The Staff Division is divided into three sections:

- (1) Personnel Section—IT: S: PL
- (2) Training Section—IT: S: TN
- (3) Personnel Research—IT: S: PR

Personnel Section.

The Personnel Section interviews applicants for positions in the Income Tax Unit and co-operates with the Civil Service Commission in arranging for appointments and the selection of new employees.

Training Section.

The Training Section prescribes and conducts the course of study which the auditors are required to take up immediately upon entering the Income Tax Unit. The auditor continues these training classes from two to three nights a week after office hours as soon as he is assigned to a section, as promotions from one section to another are based to a great

OPERATIONS OF INCOME TAX UNIT

extent upon the ratings received in the examinations given by the Unit.

The Personnel Research Section keeps a detailed record of the amount of work turned out by each auditor, the quality of the work, etc. Before an auditor can receive an increase in salary his efficiency record must show that he is entitled to it.

Personnel
Research
Section.

The Administration Division is divided into nine sections, as follows:

Adminis-
tration
Division.

- (1) Proving—IT: AD: P
- (2) Sorting—IT: AD: S
- (3) Stenographic—IT: AD: SS
- (4) Building, Equipment and Supplies—
IT: AD: BES
- (5) Files—IT: AD: F
- (6) Returns Control—IT: AD: RC
- (7) Mail—IT: AD: M
- (8) Orders and Codes—IT: AD: OC
- (9) Duplicating—IT: AD: D

The work of the Administration Division is entirely administrative and clerical; no auditors are employed in this Division. Returns are recorded, checked against assessment lists and filed by this Division. Lists of additional assessments are prepared in this Division and forwarded to the various Collectors of Internal Revenue, who send to the taxpayer notices of demand and payment. The routing of mail to the various sections and the complete upkeep

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of buildings, supervision of the guards, porters, etc., are under the jurisdiction of this Division.

General Audit Division.

The General Audit Division is divided into seven sections, as follows:

- (1) Field Audit Review—IT: G: FAR
- (2) Manufacturers—IT: G: M
- (3) Trading—IT: G: TR
- (4) Personal—IT: G: P
- (5) Transportation and Public Utilities—
IT: G: TPU
- (6) Finance—IT: G: F
- (7) Personal Service—IT: G: PS

Field Audit Review Section

The Field Audit Review Section audits the reports of the Revenue Agents and Inspectors covering cases emanating from the General Audit Division and prepares assessment letters (A-2 letters) covering these cases.

Manufacturers Section.

The Manufacturers Section audits returns of single corporations which cover any of the manufacturing industries.

Trading Section, Financial Section, Transporta- tion and Public Utilities Section.

The Trading Section, Finance Section and Transportation and Public Utilities Section each handle the returns covering the type of business its name implies; the auditors in each of these sections have made a specialty of the problems peculiar to these businesses.

Personal Returns Section.

The Personal Returns Section audits the returns of individuals, fiduciaries and partnerships, and verifies the income reported by individuals with the salary lists of corporations,

OPERATIONS OF INCOME TAX UNIT

etc., statements of dividends paid to stockholders, ownership certificates in the case of bonds, etc., etc., all of which are on file in the Bureau.

The Personal Service Section audits returns of concerns supplying domestic or professional services, operating places of amusement or engaged in the construction of plants or buildings, and of concerns which claim to have not more than a nominal capital as set forth in Section 209 of the Revenue Act of 1917, and of corporations which claim to have rendered personal service as outlined in Section 200 of the Revenue Act of 1918.

**Personal
Service
Section.**

The Field Audit Division is divided into three sections:

**Field Audit
Division.**

(1) Field Personnel Section—IT: F: FPL

(2) Field Audit Control—IT: F: AC

(3) Space and Equipment—IT: F: SE

The Field Personnel Section has charge of the personnel records of the field Revenue Agents situated in the 35 Divisions located throughout the United States.

**Field
Personnel
Section.**

The Field Audit Control Section routes the cases for field audit received from the various audit sections to the 35 Revenue Agents in Charge located in the 35 Divisions into which the United States has been divided. These Revenue Agents in Charge supervise the men assigned to them in their respective districts.

**Field Audit
Control
Section.**

FEDERAL CORPORATE INCOME TAXES

The reports of Revenue Agents covering field examinations made by them are submitted by the Revenue Agents in Charge to Washington and there pass through the Field Audit Control Section to the Field Audit Review Section of the General Audit Division.

Space and Equipment Section.

The Space and Equipment Section keeps the records with respect to equipment located throughout the country and the office space used in the various district offices, and arranges for the semi-annual inventory of field equipment and supplies.

Special Audit Division.

The Special Audit Division is divided into two subdivisions, which are further divided into sections, and four sections which are responsible directly to the Head of the Division, as follows:

Special Assessment Section—IT: SA: SM

Special Assignment Section—IT: SA: AS

Amortization Section—IT: SA: AM

Inventory Section—IT: SA: I

Consolidated Returns Subdivision—IT: SA: CR
with the following sections:

Section A. Miscellaneous—IT: SA: CR: A

Section B. Natural Resources—

IT: SA: CR: B

Section C. Transportation and Public Utilities—IT: SA: CR: C

Section D. Manufacturing and Trading—

IT: SA: CR: D

Travel Audit Section—IT: SA: CR: TA

Affiliations Section—IT: SA: CR: AF

Administration Section—IT: SA: CR: AD

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Natural Resources Subdivision—IT: SA: NR

with the following sections:

Audit Section—IT: SA: NR: A

Oil and Gas Valuation Section—

IT: SA: NR: OG

Metals Valuation Section—IT: SA: NR: M

Timber Valuation Section—IT: SA: NR: T

Coal Valuation Section—IT: SA: NR: C

The Special Assessment Section handles all returns of taxpayers who request special consideration under Section 210 of the Revenue Act of 1917, and Sections 327 and 328 of the Revenue Act of 1918. This section determines the propriety of the application of Section 210 of the Revenue Act of 1917 and Sections 327 and 328 of the Revenue Act of 1918, and if the determination is made that these provisions apply, fixes the profits tax on the basis of that paid by representative concerns engaged in a like or similar business. The taxpayer usually furnishes the names of five or six of his competitors. The auditor then uses the returns of these concerns together with several other cases if similar ones are available and arrives at an average tax. The comparatives used by this section are not available for publication. An assessment is then made on the basis of this average tax provided the amount is lower than the tax based upon the statutory invested capital of the concern under review. The usual

**Special
Assessment
Section.**

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practice is, before cases are submitted to the Special Assessment Section, to have a thorough audit made of the net income by the audit section in which the case would ordinarily be handled.

Very often, where claims are made for assessment under Section 209 of the Revenue Act of 1917, or for assessment as personal service corporations, and such claims are denied by the Personal Service Section of the General Audit Division, the returns involved are submitted to the Special Assessment Section for consideration.

Special Assignment Section.

The Special Assignment Section audits all cases, with the exception of Consolidated and Natural Resource Cases, which require particular attention due to their complexity and technical nature. To it are referred such questions as reorganization after March 3, 1917, the establishment of replacement funds and other highly technical and complicated matters which do not come within the scope of the work of some other special section. This section also cooperates in the audit of cases involving fraud.

Amortiza- tion Section.

The Amortization Section audits cases in which an amortization allowance is claimed as a deduction from income on account of facilities acquired after April 5, 1917, and before November 12, 1918, for the production of articles contributing to the prosecution of the late war and in the case of vessels acquired during the same

OPERATIONS OF INCOME TAX UNIT

period for the transportation of articles or men contributing to the prosecution of the late war. It also audits and investigates all returns filed under the Munitions Tax Acts of 1916 and 1917. There are both engineers and auditors in this section who make field investigations of amortization claims. Any of the other sections in the audit divisions which have cases where the question of amortization is involved, refer such cases to the Amortization Section, which prepares a report of its findings and routes the case back to the section from which it had been originally forwarded so that the other points involved in the case may be settled by the original section.

For instance, if the Consolidated Subdivision is working on a large case having several subsidiary companies, and several of the subsidiary companies have filed claims for amortization, the entire case is routed to the Amortization Section, where the correct amortization allowable is determined. Then the case is returned to the Consolidated Subdivision and the audit of the case continued in that subdivision, using the figures submitted by the Amortization Section as the basis for the amortization deduction.

The functions of the Inventory Section are somewhat similar to those performed by the Amortization Section. Where complicated questions of inventories are involved, the returns are referred to the inventory experts, who re-

**Inventory
Section.**

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turn the case to the original section with a report of their findings. Claims under Section 214 (a) 12 (a) of the Revenue Act of 1918 for deductions on account of shrinkage in inventory values are also referred to this section.

Consolidated Returns Subdivision.

The Consolidated Returns Subdivision handles all returns covering cases where two or more companies are affiliated in accordance with the requirements set forth in Section 240 of the Revenue Act of 1918 and Articles 77 and 78 of Regulations 41 for 1917, and determines the propriety of filing a consolidated return where claim is made that two or more corporations are so affiliated.

Affiliations Section.

Returns in this subdivision are first routed to the Affiliations Section, where it is determined whether all the companies included in a consolidated return come fully within the requirements of consolidation.

Audit Sections A, B, C and D.

From the Affiliations Section, the returns are routed to one of the four audit sections, A, B, C or D, depending upon the nature of the business of the corporations involved.

Audit Sections A, B, C and D, in the event that the cases under review have claimed amortization, or have unusual inventory problems, refer such questions to the section specializing in those features of the law.

Audit Section B of the Consolidated Returns Subdivision co-operates with the Natural Resources Subdivision, whose engineers determine

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mineral valuations and depletion deductions allowable.

The Travel Audit Section is composed of traveling auditors who make field investigations of affiliated companies and have their headquarters at Washington. They work independently of the field force, who are under the Revenue Agents in charge at the various district offices. Their reports are audited by the resident auditors in the Consolidated Returns Subdivision and assessments based upon their findings emanate from that subdivision.

**Travel
Audit
Section.**

The Administration Section has charge of all the clerical work in connection with the various sections of this subdivision, such as filing returns, routing letters, and similar duties.

**Administra-
tion
Section.**

The Consolidated Returns Subdivision has a Consulting Staff, composed of three auditors, to which the Chief of the subdivision has delegated his authority to hold conferences with taxpayers, investigate the merits of their claims or protests, and recommend adjustments of assessments in meritorious cases. They also act in an advisory capacity and assist the auditors in the various audit sections of the subdivision in the solution of any intricate questions involved in the examination of the returns under review.

**Consulting
Staff.**

The Natural Resources Subdivision has the difficult task of determining the valuation of natural resources and the rates of depletion

**Natural
Resources
Sub-
division.**

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allowable as a deduction from income in the various cases under review.

Valuation Sections.

The personnel of all of the valuation sections under this subdivision is made up of engineers, the majority of whom have made a special study of some particular natural resource such as coal, copper or timber, etc. By means of the data filed by the taxpayers and their familiarity with the natural deposits in various sections of the country, they are enabled to decide the merits or demerits of a taxpayer's valuation claim.

Audit Section.

The Audit Section reviews all returns covering natural resources with the exception of those of affiliated companies. Both the Audit Section and the Consolidated Returns Subdivision rely upon the valuation engineers to determine the invested capital value and depletion allowance properly allowable in natural resource cases.

Review Division.

The Review Division is divided into three sections as follows:

- (1) Claims Section—IT: R: CL
- (2) Audit Review—IT: R: RA
- (3) Rules and Regulations—IT: R: RR

Claims Section.

The Claims Section passes upon all claims for abatement, refund or credit except those involving consolidated returns; adjusts legacy and other special tax cases where a knowledge of older and less familiar laws is required, re-

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views all claims adjusted in the Unit and routes them to the Returns Control Section, Administration Division, for record and disposition.

The Audit Review Section is composed of auditors who make test audits of the work of the various sections, after the A-2 letters are prepared, but before they are mailed. The purpose of this review is to standardize the auditing procedure of all the sections as well as the application of the law and regulations for the Income Tax Unit as a whole.

**Audit
Review
Section.**

The Rules and Regulations Section performs the service of answering all taxpayers' inquiries in connection with the application and interpretation of the various sections in the Revenue Acts and articles in the Regulations. All questions involving extensions for filing returns are submitted to this section for approval. It is advisable to address requests for rulings to the Commissioner of Internal Revenue in Washington, D. C., instead of to local Collectors, as rulings made by Collectors or Revenue Agents are subject to approval by the Commissioner.

**Rules and
Regulations
Section.**

The Statistical Division is divided into the following sections:

**Statistical
Division.**

- (1) Compilation and Analysis—IT: ST: CA
- (2) Tabulation and Sorting—IT: ST: TS
- (3) Edit and Code—IT: ST: EC
- (4) Card Punch—IT: ST: CP
- (5) Research—IT: ST: R

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The various sections of the Statistical Division tabulate the information shown on the return, analyze and classify this information and prepare interesting statistics showing the relative earnings of the various industries and professions, and collect other valuable information for sundry purposes.

The Research Section selects returns of representative taxpayers and prepares special statistics for use in the administration of Section 210 of the Revenue Act of 1917 and Sections 327 and 328 of the Revenue Act of 1918.

Deputy
Commissioner har-
monizes
work of
various
divisions.

The Deputy Commissioner harmonizes the work in the various divisions by having the Executive Committee, which is composed of the heads of the divisions, meet with him and discuss their problems about once a week.

The head of each division periodically calls a meeting of all subdivision and section chiefs and informs them of any change of policy decided upon by the Executive Committee, and the chiefs present such problems for discussion as they see fit.

The chief of each subdivision and section similarly calls meetings of sub-chiefs and section unit auditors. Each section is divided into units of four or more auditors with a section unit auditor in charge of each group. These sub-chiefs and section unit auditors in turn give the men under them their instructions. By means of this system of meetings, the Dep-

OPERATIONS OF INCOME TAX UNIT

uty Commissioner keeps in constant touch with the entire organization.

2. Mechanical Features of Handling Returns

It is of utmost importance to taxpayers to familiarize themselves with the *modus operandi* of the Bureau with respect to the handling of returns for the reason that usually considerable time and, in a good many cases, money may be saved.

The routine of returns under the Revenue Act of 1918 begins with the filing of the return in the Collector's office and the payment of the first installment of taxes. The other three installments are due at intervals of three months thereafter; or the tax may, at the option of the taxpayer, be paid in a single payment on or before the time for filing the return. An unconditional extension of time for filing a return will postpone the date of payment of the first installment, but will not postpone the date of payment of the other installments, unless so specified in each case. Upon failure to pay an installment on time, all of the tax remaining unpaid becomes due and payable upon notice and demand by the Collector.

Return
filed in
Collector's
office.

Payments
of tax to
Collector.

Upon recomputation of the tax, as the result of audit of the return by the Bureau, if the amount already paid exceeds the correct amount of the installment or of the whole tax, the excess is credited against subsequent installments

Recompu-
tation of
tax.

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or may be claimed as a credit by the taxpayer against other similar taxes then due from the taxpayer, or may be claimed as a refund. If the amount already paid is less than that which should have been paid, the difference, to the extent not covered by any credits then due to the taxpayer under Section 252 of the 1918 Statute, is payable upon notice and demand by the Collector. (See Section 252 of the Revenue Act of 1918 and Articles 1034-1036 of Regulations 45 Revised.)

Interest on postponed installments.

Where the time for payment of any installment of the tax is postponed at the request of the taxpayer, interest at the rate of 6 per cent per annum is added from the original due date. (See Article 1003, Regulations 45.)

Interest on disallowed abatement claims.

In the case of rejected claims for abatement of taxes assessed under Revenue Acts prior to the Revenue Act of 1918, interest is collectible at the rate of 1 per cent per month; but in the case of the rejection of claims for abatement of taxes assessed under the Act of 1918 interest is collectible at the rate of 6 per cent per annum, except in the case of disallowed claims for inventory losses, in which case the interest rate is 12 per cent per annum.

Extensions for filing returns.

Penalties for delinquencies in filing returns are imposed. It is therefore advisable that taxpayers write in advance, or telegraph, to the Commissioner of Internal Revenue, Washington, D. C., stating the reasons why an extension

OPERATIONS OF INCOME TAX UNIT

should be granted for the filing of returns. If such reasons are acceptable to the Commissioner an extension is granted. In the past the Bureau has been considerate in the handling of extensions. Of course, abuse of such liberality may lead to stricter procedure.

Penalties for failure to file returns, for understating tax liability and non-payment of tax are fully covered in the regulations and supplemental decisions.

If a corporation in process of dissolution does not reserve sufficient funds to pay any income tax assessed against it, the liability for the amount of tax remaining unpaid attaches to the individual stockholders and, if necessary, legal proceedings may be instituted against them for collection of the tax.

In case of dissolved company, tax attaches to stockholders.

When the taxpayer makes his payment of taxes, it is advisable to obtain a signed receipt. This, together with the canceled check, should be kept carefully for future reference. In case evidence as to the payment of taxes is required a typed copy should be furnished of both the canceled check and receipt. It is sometimes better to furnish such evidence in the form of a "photo stat."

Receipts for taxes.

In some of the Collectors' offices, because of the simultaneous filing of a large number of returns and because of the inadequate number of clerks, errors are liable to occur and in a good many instances taxpayers have been in-

FEDERAL CORPORATE INCOME TAXES

convenienced considerably because they did not retain their original receipts.

Returns
forwarded
by Collector
to Wash-
ington.

The Collector makes daily deposits of the taxes received and indicates on each return the amount of taxes paid. He places the amount of taxes due on a list which is forwarded to the Commissioner of Internal Revenue.

After the returns are listed they are forwarded to the Commissioner of Internal Revenue at Washington, D. C., where they are sent to the Proving Section.

Routing of
returns.

This section checks the returns against the assessment list and proves the amount supposed to have been paid. The returns then go to the Statistical Division, where they are coded and certain statistical information taken therefrom. From there they are routed to the Returns Control Section. This section checks them against its block list. They are then coded and carded according to the library code system. The cards are then verified with the returns. The returns then go to the general files and the cards are also filed. When the returns are assigned to the audit sections, they are routed by the General Files Section to the Returns Control Section and from there to the proper audit section. If any returns are transferred from one audit section to another, they go through the Returns Control Section in order that a proper record of the movements of returns may be kept.

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After the returns are assigned for audit, the resident auditor decides into which of the following classifications the case falls:

Returns reach Audit Sections.

- (a) No additional tax;
- (b) Overassessment or additional tax on basis of office audit;
- (c) Requiring field audit;
- (d) Requiring consideration by another section or subdivision.

"No additional tax" cases are placed in the dead file. These returns may, however, be referred to some time in the future.

"No additional tax cases."

In cases showing overassessment or additional tax on the basis of an office audit an A-2 letter is prepared notifying the taxpayer regarding the findings of the Bureau. No taxpayer should neglect to pay attention to such a letter and either explain disputed questions by letter or arrange for an immediate conference in Washington so that any erroneous assumption or conclusion by the Bureau may be removed and thereby avoid an assessment which may work a hardship on the taxpayer. It is customary for the Bureau to give the taxpayer 30 days from the date of the A-2 letter to present such facts as may warrant an adjustment or withdrawal of the contemplated assessment. Once the assessment is on the list and forwarded to the Collector the only remedy lies in the filing of a claim in abatement, which may prove an expensive procedure because it is op-

"Additional tax" cases.

FEDERAL CORPORATE INCOME TAXES

tional with the Collector whether or not to accept a claim in abatement unless it is supported by a bond which, depending upon the rates in each particular locality, may mean a premium as high as 8 per cent of the face value of the bond furnished.

Audits requiring a field examination act as an automatic alarm clock to the taxpayer, for the revenue agent is supposed to leave with the taxpayer a report of adjustments made by him which will enable the taxpayer to prepare a brief contesting any points in dispute and to arrange for a conference *before* an A-2 letter is received. Whenever the Revenue Agent refuses to leave a report of his findings, the matter should be taken up immediately with both the local Revenue Agent in Charge and the Commissioner of Internal Revenue in Washington, D. C.

Cases requiring field audit.

It usually takes about a month before the Revenue Agent's report reaches the resident auditor's desk in Washington and about another month before the A-2 letter is written. If the taxpayer takes immediate action he will surely have sufficient time to submit the facts to the Bureau so as to clear away any erroneous conclusions which may have been reached by the investigator and which the taxpayer has been unable to dissipate in conference with the Revenue Agent during the course of the examination.

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The fourth classification, cases requiring consideration by another section or subdivision, does not affect the process of the audit as far as the taxpayer is concerned, and for this reason it does not need any discussion.

What happens to the A-2 letter? Unless the taxpayer writes to the Department within 30 days from the date of the A-2 letter, or arranges for a conference and files a brief 3 to 10 days before the conference takes place, which is usually scheduled within 30 days from the date of the A-2 letter, the A-2 letter is released to the Proving Section of the Administration Division, where the amount of additional tax shown thereon is listed. The Collector of each district receives a list monthly and as soon as possible sends out notices of assessment and demand for payment. Payment must be made within ten days from date of such notice. If such payment is not made, collection may be effected by distraint.

Assessment
based on
A-2 letter.

If no action is taken by the taxpayer within the 30 days' grace, and the assessment takes its usual course, it will ordinarily take about sixty days from the date of the A-2 letter before notice of assessment and demand for payment is given by the local Collector.

In extremely meritorious cases and under exceptional circumstances the Bureau will prepare on the basis of facts submitted revised A-2 letters, before notice of assessment reaches the

Collector
may file
claim for
abatement.

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Collector, with instructions to the Collector to file claim for abatement of the amount of the assessment erroneously made. However, taxpayers should under all circumstances present their case before the expiration of 30 days from the date of the A-2 letter, if they wish to avoid "red tape" and technicalities.

**Taxpayer
may file
claim in
abatement.**

If the taxpayer has failed to take any action before notice and demand for payment has been received, he has the privilege of filing with the Collector of Internal Revenue in his district a claim for abatement of the assessment (or part thereof), if he is of the opinion that such assessment (in whole or in part) was erroneously made. As stated before, this procedure may involve expenses which, in the case of large assessments, may reach considerable sums.

**Claims for
refund.**

Claims for refund have been filed by many taxpayers who have erroneously paid taxes in excess of what they owed the Government. Such claims may be changed into claims for credit and deducted from the next installment of taxes due. In this connection see Article 1035, Regulations 45 Revised.

Taxpayers usually find it more advantageous, where there are taxes due the Government, to file claims for credit instead of claims for refund, which are usually used only where there is no prospect of future liability for taxes to the Government, or where the taxpayer is not sure of his ground.

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The administrative mechanics of the Bureau are not complicated, but in many cases it is necessary to be thoroughly conversant with the details involved in these procedures so that the taxpayer may avoid unnecessary expense, inconvenience and embarrassment.

It may be stated here that in the case of consolidated returns the Commissioner prefers the parent or principal company to assume the entire tax liability and make any necessary adjustments with the subsidiary company through intercompany bookkeeping entries. Whenever an affiliated group files its return on Form 1120, the subsidiaries are required to file Form 1122 in the offices of the Collectors of their respective districts.

Allocation of tax in affiliated companies.

Where the parent or principal reporting company allocates to itself the entire tax due on the basis of the consolidated return, Form 1122 for the subsidiary should indicate no tax due, regardless of what adjustments may be made on the books of the different companies with respect to such taxes. This procedure may avoid a great deal of inconvenience.

A claim for credit for taxes paid in excess of the amount due by one of the companies of a consolidated group cannot be used to offset additional tax due from one of the other companies of the group. The claim for credit may be applied merely against the outstanding assessment of tax of the particular company filing

Claims for refund or credit in case of affiliated companies.

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the claim. If the over-payment is in excess of the outstanding assessment, a claim for refund of the overpayment in excess of the outstanding assessment may be filed.

Commissioner's power to refund taxes limited by the statutes.

It should be borne in mind by the taxpayer that the Commissioner has authority to refund a tax only in a case where a claim has been filed which is not barred by any time limitations in any of the Revenue laws or where the taxpayer has a legal right to file a claim for the refund of the tax.

Suits for recovery of taxes.

A taxpayer cannot bring suit for recovery of taxes paid under protest until an appeal by a claim for credit or refund shall have been duly made to the Commissioner and a decision of the Commissioner has been had thereon, unless such decision has been delayed more than six months. No suit or action may be brought after two years from the time cause of action accrued. No suit for the purpose of restraining the assessment or collection of any tax can be maintained in any court.

The organization and routine as outlined in the foregoing and in Chapter I are as they exist at the time of writing this book. It is to be noted, however, that from time to time there are changes in organization and transfers of functions from one division or section to another or others in the Unit.

CHAPTER III

PERTAINING TO TAXABLE NET INCOME

1. Gross Profit on Sales—2. Miscellaneous Income—3. Deductions from Income

NET income for income tax purposes is not necessarily the same as that known to the business man, or that to which an accountant would certify, but is that defined by the various income tax statutes and consists of certain items of income less certain deductions all of which are set forth in the several statutes. In the case of trading, manufacturing and similar businesses, the determination of the correct gross profit on sales is an essential element in the ascertainment of net income for tax purposes.

1. Gross Profit on Sales

By gross profit on sales is meant the difference between gross sales (less returns and allowances) and the cost of sales. In the case of a trading concern the cost of sales would consist of the purchases of the year, plus the inventories at the beginning of the year, less the inventories at the close of the year. Manufacturers differ in their methods of arriving at the cost of sales, some including items embrac-

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ing not only the material and productive labor cost, but certain overhead expenses.

Sales.

The Internal Revenue Agent at the outset of his investigations often directs his attention to the gross profit on sales, and the taxpayer should be in readiness to afford him every assistance in mastering the details of the method in use in computing the cost of sales. If there have been any offsetting entries or corrections in the sales account, they should be fully explained, otherwise the examiner, in making tests of the postings and entries in the sales account, may draw erroneous conclusions. In order to verify the correctness of sales as recorded, it is sometimes desirable to reconcile the quantities sold with inventories at the beginning of the period, plus the units purchased or produced, less the inventories on hand at the close of the period. Some concerns check their shipping memoranda with the sales books, taking care to strike out any items shipped after the date of the closing of the books. Others keep no separate sales accounts, but rely on their merchandise account to show the figures necessary for computing sales, and in order to verify the correctness of this account test the postings indicating returns, allowances for trade discounts, allowances on sales and outward freight.

Purchases.

It is important that the purchases be correctly recorded. It might be desirable for the

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taxpayer, before preparing his return, to verify his total purchases by comparing the totals of the invoice journal or voucher register with those of the merchandise or inventory account. Care should be taken not to include in these accounts items which represent distributions of profits made possibly in the form of commissions, salaries, etc.

The methods of various concerns in compiling inventories differ greatly, due to choice and the wide diversity of physical material. The following points are of interest in connection with inventories:

Inven-
tories.

(1) *Beginning of the Period.*—The inventory as shown in the books should be carried over correctly from the previous period and should agree with the amount reported by the taxpayer as the closing inventory on the previous year's return.

(2) *End of the Period.*—The total of the inventory for the end of the period should agree with the inventory credited to the merchandise or profit and loss account.

(3) *Reconciliation with Balance Sheet Figures.*—The inventories used in arriving at cost of sales should be reconciled with those shown on the balance sheets at the beginning and end of the year submitted with the income or profits tax returns.

(4) *Basis for Inventory.*—Prior to the close of the taxable year 1917, the Bureau permitted

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inventories to be taken only on the basis of cost. Beginning with the close of the taxable year 1917, inventories were permitted to be priced on the basis of "cost," or "cost or market, whichever is lower."

(5) *Checking Inventory.*—Many concerns have employees, who are sometimes careless or incompetent, assist in taking the inventories, so that discrepancies of various kinds occur, which occasionally result in large errors. It is therefore important to make sure that the inventory is as accurate as it may reasonably be made.

Executives of large concerns, or their chief accounting officers, in order to satisfy themselves as to the reliability of the inventory figures, usually employ certain checks, among which are the following:

Select items in the inventory for the end of the year and compare the prices with the inventory prices of similar items at the beginning of the year, making sure a satisfactory reason exists for any differences or discrepancies disclosed; ascertain fully what any "lump" sum adjustments applied to the totals of classes or groups or to the grand total represent; test the accuracy of the footings of various sheets, the transfer of totals from one sheet to another and the accuracy of prices applied to large items; compare the totals of inventories with those of preceding years and note (a) the ratio of each inventory to the sales of the preceding

TAXABLE NET INCOME

year, (b) the quantity increases or decreases as distinct from value increases or decreases, (c) prices as compared with invoices, and (d) the rate of gross profit on sales for the year under review and for several preceding years.

(6) *Inventories of Dealers in Securities*.—A taxpayer is not allowed to employ the method of averaging the cost prices of securities as the basis for inventory, nor is he permitted to include in the inventories that are used as bases for determining “cost of sales” any securities purchased for investment. (Article 1585, Regulations 45.)

In the case of dealers in securities, it is sometimes necessary to test at least half of the items in the inventory to be assured of the correctness of prices and their conformity with the basis adopted for inventory purposes. The Bureau will no doubt want to know whether the basis on which the inventory is taken is in accordance with the established custom of the concern, or represents a change.

(7) *Inventory Practices*.—Taxpayers are required to file sworn inventory forms with their returns. Items considered as selling or administrative expenses should not be included in factory overhead charges. If the taxpayer claims losses in inventories and from rebates as permitted in Section 214 of the Revenue Act of 1918, he should guard against reporting as losses any items due to rebates on sales unless

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the profits from such sales have been reported as income in the 1918 return. Losses from waste or shrinkage due to handling the commodity in certain lines of business cannot be claimed under this section, as such items will automatically adjust themselves in the computations of the cost of goods sold.

Under Regulations 45 taxpayers were permitted to exercise their option commencing with the close of the taxable year 1918 in pricing inventories at "cost" or "cost or market, whichever is lower" but with the provision that the method selected would have to be followed in succeeding years. A recent Treasury Decision, however, authorizes taxpayers who previously exercised their option of reporting inventories at "cost" to change to "cost or market, whichever is lower" for the taxable year 1920, but with the provision that the method of "cost or market, whichever is lower" if adopted would have to be followed in the future, unless permission to change is obtained from the Commissioner of Internal Revenue. As cost figures were higher than market prices at the close of 1920 in a great many businesses, this decision afforded many taxpayers considerable relief in permitting them to anticipate losses which would occur in the succeeding year or years. Article 1584 of Regulations 45 Revised, dealing with market values, has been revised, allowing the current bid price prevailing at the date of

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the inventory to be used in the cases of (a) goods purchased and on hand, (b) basic elements of cost (materials, labor and burden) in goods in process of manufacture, and (c) finished goods on hand; however, goods on hand or in process of manufacture for delivery upon *firm sales contracts* at fixed prices entered into before the date of the inventory must be inventoried at cost.

If the taxpayer is a manufacturer who maintains an adequate system of cost accounts, he should avoid including such items as selling expenses, interest on plant, or interest on other investments in inventory figures. Adequate systems will greatly facilitate the work of the Agent, particularly in passing upon the adopted method of taking inventory. The Agent will no doubt be interested in determining whether (a) the articles in the inventory are assumed to be those most recently purchased, (b) the goods can be identified by specific lot numbers, invoices or other definite records of quantities and prices, (c) any system of average prices is used, as when purchases are added to the inventory at the beginning of the year and the resultant average price obtained applied to the inventory at the end of the year, and (d) the inventory prices are based upon selling prices, minus arbitrary percentages, to arrive at an estimated cost.

Taxpayers who use the perpetual inventory

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system should be prepared to indicate exactly what adjustments were made when the physical inventory was taken, or, if none was taken, whether the cost of goods sold was computed on the basis of the cost as shown in the stock records.

The Revenue Act of 1918 contains no specific requirements as to the basis upon which inventories shall be taken, other than that inventories shall be taken "upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income." However, only two general bases of inventory-taking applicable to all businesses have been approved, to wit: (a) Cost, and (b) cost or market, whichever is lower. Where cost prices are used in either (a) or (b) the Bureau of Internal Revenue has generally held that goods taken into the inventory which have been so intermingled that they cannot be identified with specific invoices are to be considered as the goods most recently purchased. The Bureau has, however, in particular and meritorious cases, permitted deviations from its rigid general rules of inventory-taking.

Some of the bases of inventory-taking in considerable use, but to which the Commissioner has not given his general approval, are the following: (a) Deducting from the inventory a

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reserve for price changes, (b) taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value, (c) omitting portions of the stock on hand, (d) using a constant price or nominal value for a so-called normal quantity of materials or goods in stock, (e) including stock in transit, either shipped to or from taxpayer, the title of which is not vested in taxpayer, (f) using a constant, an average, or a nominal price, (g) average cost, (h) market price applied to all items regardless of cost.

The principal elements entering into the cost of manufacturing or otherwise producing goods are labor, materials and supplies, and overhead or burden.

Cost of manufacturing or otherwise producing goods.

(1) *Labor*.—The taxpayer cannot include in the amounts paid for labor any bonuses disallowed by Article 138, Regulations 33 Revised, and Article 107, Regulations 45 Revised. In all probability the examiner will not wish to extensively verify rates, extensions or footings of payrolls, but the taxpayer as a rule is called upon for an explanation of any adjustment of appreciable amount as applied to the totals of classes or groups, or to the grand total. In verifying labor cost several tests of the total weekly or monthly charges for labor in the books, by reference to the payrolls, may be made.

(2) *Cost of Materials and Supplies*.—The

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Regulations stipulate that cost of materials and supplies used in operations and maintenance may be deducted to the extent that they are actually used or consumed. Properly taken inventories are a means of arriving at the amounts deductible. In the case of supplies, where inventories are not taken, it is permissible for the taxpayer to take as a deduction the cost of the supplies purchased during the period, provided this procedure will correctly reflect the net income.

(3) *Overhead or Burden*.—The methods of distributing overhead and the expenses included therein vary greatly. Any recognized accounting method may be used, provided it reflects the true taxable income.

Some cost systems include as overhead items which are not deductible under the law or regulations, as, for example, interest on capital invested in the business which under certain cost systems is included in arriving at the machine hour rates in each department, thus becoming a part of the cost of production and inflating cost of goods sold and inventories on hand. Care should be taken to eliminate all such items from the overhead, for income tax purposes.

It is also important to make sure that the expenses included as a part of cost of goods sold are not again taken as a deduction under the separate items of expense called for on the return.

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2. Miscellaneous Income

The taxpayer may be requested to provide copies of royalty agreements for the examiner's use in verifying the amount of income from royalties. In this connection it is important to determine whether any affiliations between the taxpayer and parties from whom rents and royalties are received are of such a nature as to call for a consolidated return.

Income
from
rentals,
royalties,
etc.

The examiner often analyzes the interest account, especially when the interest received and the interest expense are included in the same account. This step is made necessary by the requirement on the return form that these items be shown separately. The amount of interest allowable as a deduction from gross income in 1917 is limited in amount by Article 180 of Regulations 33. Under the Revenue Act of 1918, domestic corporations may deduct all interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from income tax.

Income
from
interest.

All the issues of Liberty Loan bonds, also Victory notes, are exempt both as to principal and interest from all taxation imposed by the United States, any state or any of the pos-

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sessions of the United States, or local taxing authority in the United States, except Federal estate or inheritance taxes and Federal graduated additional income taxes, such as surtaxes, excess profits and war profits taxes, upon the incomes or profits of individuals, partnerships, associations or corporations. Therefore, the interest received from any of the above issues should be eliminated from the income subject to the normal rates of tax.

In cases where a bank purchases United States Government bonds in excess of subscriptions by customers, such bonds are to be regarded as the property of the bank. The interest on such bonds is taxable income to the bank only to the extent provided in the Liberty Loan acts and supplements thereto. On the other hand, interest on bonds subscribed to by customers on which no default has occurred must not be considered income to the bank; however, interest received by a bank from its customers on account of bonds carried for the customers is taxable income to the bank, being in reality interest on money loaned to customers.

Income
from
dividends
and
interests.

If the taxpayer holds a large amount of securities of various corporations he will find that a schedule setting forth the following data will be of help to him in preparing his return and to the Agent in making his examination: (a) Date of purchase, (b) name of security, (c)

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nature of security, (*d*) par value held, (*e*) denomination of shares, (*f*) number of shares or bonds held, (*g*) investment in each security as shown in the books, (*h*) amounts paid for the investment, (*i*) interest or dividend rate, (*j*) dates when interest or dividends are payable, (*k*) amount of interest or dividend income, and (*l*) if disposed of during the taxable year, date of disposition, amount realized, and profit or loss resulting therefrom.

In the case of income from dividends received from a foreign corporation having taxable income from sources within the United States, Regulations 33 and 41 for 1917 hold that, for the purpose of the war income tax of 4 per cent and the excess profits tax for 1917, the same proportion of the dividends received from the foreign corporation as the net income of such corporation from sources within the United States is of its entire net income, is not taxable.

For 1918 and subsequent years, the Bureau has held that income from dividends received from a foreign corporation having taxable income from sources within the United States, however small such income may be, is subject to neither the normal tax nor the profits taxes.

As the Revenue Acts of 1917 and 1918 are practically identical with reference to dividends from foreign corporations, in the opinion of the author the ruling with reference to 1918 dividends should also apply to the year 1917, since

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the Bureau has held consistently that the most recent rulings supersede all previous rulings provided there is no material difference in the provisions of the tax laws of prior years upon the points in question.

Dividends, whether from domestic or foreign corporations, received in 1917, but paid out of earnings prior to 1917, and subsequent to March 1, 1913, are taxable at the rates in effect for the years when the earnings were accumulated. Dividends from foreign corporations having no income from sources within the United States received in 1917 and paid out of earnings accumulated in 1917 are subject to all rates of tax in effect for 1917. Dividends from foreign corporations having no income from sources within the United States received in 1918 and subsequent years and paid out of earnings accumulated since March 1, 1913, are subject to all rates of tax in effect for the years in which such dividends are received.

If the taxpayer has reported stock dividends as income, an amended return and a claim for refund or credit may be filed for overpayment of tax, unless such claim is outlawed under the time limitation of the Revenue laws. (See Section 252 of the Revenue Act of 1918.)

Income
from
long-term
contracts.

Concerns engaged in contracting operations who have uncompleted contracts which in some cases run for periods of several years have the option of reporting net income from these long-

TAXABLE NET INCOME

term contracts on either of the following two bases: (a) On the basis of completed work, that is, on jobs which have been finally completed, the net income is reported in the year in which the work is completed. When this method is used all expenditures made on account of such completed contracts are taken as deductions from gross income in the year the completed contracts are reported and expenditures on uncompleted contracts are not deductible. (b) On the basis of the estimated percentage of completion, that is, the income to be returned each year during the performance of a contract is computed upon the basis of expenses incurred on such contract during the year; e. g., if one-half of the estimated expenses necessary to the full performance of the contract are incurred during the year, one-half of the gross contract price should be returned as income for that year. Upon the completion of the contract if it is found that the apportionment of income of any year or years has been overstated or understated, the taxpayer should file amended returns for such year or years. Whichever of the above methods is adopted will have to be followed consistently in subsequent years.

When the taxpayer has income to report arising from the sale of a capital asset, he should be able to furnish the Agent the following information: (1) Description of asset sold, (2) the proceeds from the sale, (3) cost of the asset, (4)

Income
from the
sale of a
capital
asset.

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year acquired, (5) if acquired prior to March 1, 1913, its fair market value on that date with a full description as to the manner in which this value was determined, and (6) depreciation or depletion actually incurred and the amount deducted in income tax returns of the company on account of the property in question since March 1, 1913, or since the date of acquisition if acquired after March 1, 1913.

If upon checking the depreciation or depletion charged off on capital assets it is found that an insufficient amount has been taken, the examiner usually makes the necessary adjustments and increases the income reported from the sale, or in the case of excessive depreciation or depletion adjusts the income from the sale of the asset accordingly.

**Income
from sales
on install-
ment plan.**

In sales of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price. For instance, in a certain case where a stockholder of a corporation sold some of his stock to employees of the company for a consideration of 10 per cent cash and the balance in installment notes covering a period of ten years, the Bureau held that that proportion of each installment payment received during the tax-

TAXABLE NET INCOME

able year which the gross profit to be realized bore to the gross contract price should be reported as income for the year in which payments were received.

It has been held by the Bureau in a certain case where the stockholders of a corporation sold their shares in the corporation for a price in excess of cost and received a cash payment not in excess of 20 per cent of the total price, the purchasers having agreed to pay the balance in a number of semi-annual installments and deposit collateral with trustees as security for the faithful performance of the contract, the transaction was not an installment sale within the meaning of Article 42, Regulations 45. The entire consideration involved in the sale had to be treated as the equivalent of cash in the year when the sale was consummated.

In a case similar to the above, with the exception that the notes of the buyers could not be discounted or sold on account of lack of credit of the buyers, such notes were not regarded as the equivalent of cash and the vendors were permitted to report as their income only a portion of the total profit based on the payment actually received in each year. It can readily be seen from the above citations that each case is decided by the Bureau on its individual merits.

When reporting income from a branch at a net figure, the taxpayer would facilitate the

Income
from
branches.

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audit by furnishing the Agent with an analysis showing the nature and amount of the gross income from the branch in question, as well as the nature and amount of expenses applicable thereto.

Premiums on stock.

Article 542, Regulations 45, states that a premium received on the sale of a corporation's capital stock is not income to the corporation, nor is any discount on such sale a loss. Sales of the corporation's capital stock are considered capital transactions and the proceeds of such sales are treated as capital and do not constitute income of the corporation; the same principle is followed by the Bureau for the taxable year 1917 and prior years.

Premiums on bonds.

Article 544, Regulations 45, states that if bonds are issued at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds and if the bonds are issued at a discount, the discount is deductible as interest but should be amortized over the life of the bonds.

Occasionally the method of handling premium and discount on the sale of capital stock is confused with the method of handling premium and discount on the sale of bonds, which naturally results in erroneous deductions and erroneous taxable income.

Liquidation dividends.

A careful check of all credits made during the year to investment accounts in which are included any stocks of other corporations, some-

TAXABLE NET INCOME

times reveals that so-called liquidation dividends were received. Article 1548, Regulations 45, indicates that liquidation dividends may result in taxable income or deductible loss. Taxpayers very often have disregarded this provision in the preparation of their returns.

3. Deductions from Income

In case officers' salaries figure largely among the business expenses, the taxpayer would strengthen his case materially and also expedite the work of the examiner by preparing a list of officers connected with the company for all years beginning with 1916, and on this list showing separately the amount of salaries, bonuses or other compensation paid them and the number of shares of stock owned or controlled by them, both common and preferred, and the reason for any increases in salaries. If any bonuses were paid, the Agent will probably wish to ascertain the basis upon which they were computed in the taxable as well as in prior years.

Compensation for services rendered.

Where an examiner is inclined to think salaries excessive, the taxpayer might give in detail the nature and duties of the several officers involved, indicating the amount of time devoted to the business and the proportionate amount of time and attention the officer directs to any other enterprises with which he may be connected. Article 105, Regulations 45, provides that "payments on a contingent basis are not

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to be treated fundamentally on any basis different from that applying to compensation at a flat rate."

In certain cases where contracts were made on contingent bases prior to the taxable year, as the result of free bargaining between the taxpayer and employees, even though in the actual working out of the contract the compensation may have been greater than the amount which was ordinarily paid, the Bureau has allowed such amounts as deductions.

The Bureau has in certain instances permitted deductions from gross income on account of payments as compensation made under a "tantieme" plan, even though such payments appeared to be excessive, on the ground that the arrangement of payment under the particular "tantieme" plan was entered into before the taxable year in good faith and as the result of reasonable business procedure.

The compensation, whatever the basis, to be deductible from gross income, must of course be for services rendered, and must be reasonable in amount. What is reasonable depends upon the circumstances of the particular case. Where compensation takes the form of a percentage of the net profits of a corporation, such compensation is deductible from gross income, if the payment is made solely for services rendered and in accordance with an arrangement or understanding entered into in good faith.

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Payments made as compensation for services rendered, which under proper accounting procedure should be capitalized, are not deductible as expenses. Thus commissions which are paid for underwriting the capital stock of a corporation are not deductible from gross income. The taxpayer should, therefore, not include such commissions among "labor, wages, commissions, etc.," in determining net income for income tax purposes.

Incidental repairs or those required to keep the property in an efficient operating condition are expenditures for which a proper reserve for depreciation does not necessarily provide and therefore are allowable as deductions in addition to the amount charged off for the depreciation of the property. Many concerns charge all their repairs, both incidental and heavy, to their repairs and replacement account, which procedure necessitates that the account be analyzed and items segregated as between incidental repairs and repairs in the nature of replacements.

Repairs
and re-
placements.

Repairs in the nature of replacements should not be included as deductions from income, as they prolong the life of the property and arrest deterioration. The cost of such repairs should be charged against the depreciation reserve.

The Bureau of Internal Revenue has, however, in certain cases, where the accounting system of the corporation did not provide for de-

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preciation, permitted replacements to be taken as a deduction from gross income.

Additions and betterments.

Additions and betterments to property are not allowable as deductions in arriving at net income, and the taxpayer is required to capitalize such expenditures by charging them to the asset accounts as an increase in those assets.

Where new property represents an improvement or betterment, as well as a replacement of property which was in existence, the usual rule is to capitalize the cost of such new property, while the cost of the property replaced, less the depreciation which may have occurred in prior years, is treated as a deduction.

Advertising.

Most concerns charge their advertising expenses to a special account or to the general expense account and write them off at the end of the year to profit and loss. Other concerns capitalize their expenditures for advertising and consider the payments as amounts paid for goodwill. Either method is acceptable, provided the taxpayer consistently follows the method adopted. Expenses incurred in advertising and promoting the sale of Liberty bonds and war savings stamps over a corporation's name are deductible.

Donations.

Donations by individuals are deductible within certain limitations, but if the taxpayer is a corporation, they are deductible only when made for purposes connected with the operation of its property and limited to charitable institu-

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tions, hospitals or educational organizations conducted for the benefit of, or which are of direct benefit to, its employees or their dependents. The taxpayer, therefore, should make sure that the donations taken as deductions come within the provisions of the regulations, as the Bureau generally applies the 5 per cent negligence penalty to erroneous deductions of this nature.

Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are considered gratuities and are not allowable deductions from gross income.

Pensions are allowable deductions when paid **Pensions.** to retired employees or to their families or to others dependent upon them. The amount of salary of an officer or employee paid for a limited period after his death to his widow or children in recognition of services rendered by such officer or employee is deductible.

Amounts paid into pension funds for the benefit of employees may not be deducted until actually paid to the employees if such pension funds are under the control of the taxpayer. Amounts paid by a corporation into a pension trust fund which is separate and distinct from the corporation, as an irrevocable trust fund for the benefit of employees, are deductible.

The taxpayer should include in the miscella-

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Miscellaneous expenses.

neous expense account only items of a nature which cannot be included in specific classifications. The Bureau or its field examiners, as a rule, require taxpayers to furnish an analysis of this account. Many taxpayers have, through error, included in the miscellaneous expense account Federal income and profits taxes, expenditures for betterments, furniture, fixtures, equipment, etc., and in some instances donations. Although the charges to this account are often very numerous it is advisable for the taxpayer to make an examination of the account in order to make sure that non-deductible items have not been taken as deductions from income.

Losses.

The regulations specifically provide that deductions for losses must represent losses actually sustained and properly charged off during the year, through closed and completed transactions, and which losses are not compensated by insurance or otherwise. There are certain losses which may have been recorded on the books of the taxpayer and also taken as deductions on the return, but which are nevertheless not deductible, as, for example, shrinkage in the value of securities when the taxpayer is not a dealer in securities.

Loss in inventory and from rebates.

Article 261 of Regulations 45 Revised permits deductions from net income for the taxable year 1918 for losses resulting (a) from material reductions (not due to temporary fluctuations) after the close of the taxable year 1918

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of the values of inventories for such taxable year, and (b) from actual payments after the close of the taxable year 1918 of rebates in pursuance of contracts entered into during such year upon sales made during such year. The taxable year of the taxpayer, whether calendar or fiscal, is meant in every case. Such deductions may not be taken directly on the return; they may, however, be secured by two methods; viz., by a claim in abatement or by a claim for refund.

The Bureau has ruled that claims for losses in inventories of the taxable year 1918 are to embrace all items of the taxpayer's inventories so that gains in any sales will be offset by losses in others. If the final result shows a net gain as the result of all inventory items sold, no claim for loss in any particular item or items will be allowed. "Temporary fluctuation," as used in the statute, means a fluctuation in prices which does not develop into a steady market.

Rebates paid after the close of the taxable year 1918, other than those paid in pursuance of contracts entered into during such year upon sales made during such year, are not allowable claims under Article 261.

In fixing the cost of manufactured articles inventoried, no claim should be made for the loss of an anticipated profit on labor or material used in producing the article.

Loss of
anticipated
profit.

The loss due to voluntary removal or demo-

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Removal of buildings.

lition of buildings, incident to renewals and replacements, is usually deductible from gross income in the sum representing the difference between the depreciated original cost, or the fair market value as of March 1, 1913, if owned on that date, less accrued depreciation thereon to date of removal, and salvage value; but when a taxpayer buys real estate upon which is located a building which he razes with a view to erecting another building on the site, it is considered that the taxpayer has sustained no deductible loss or deductible expense on account of cost of removal, as the value of the land purchased is presumed to be equal to the purchase price of the land and building, plus the cost of removing the old building.

Bad debts.

Where a taxpayer wishes to claim amounts for bad debts it would be advisable to make full, complete and final entries for all such claims. Such loss on bad debts should be credited to the accounts or notes receivable accounts and charged off to profit and loss or to the reserve for bad debts which has been set up. Often taxpayers claim the total amount reserved for bad debts as a deduction, which deduction is entirely proper if it represents bad debts written off the books and it can be shown conclusively that all the debts represented by the reserve were actually determined to be worthless in the taxable year.

Where loss from fire, floods, etc., is claimed,

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care should be taken to deduct from the amount of loss any insurance received in arriving at the sum claimed as a deduction in the taxpayer's return. A taxpayer would expedite the audit of his returns if he would present for the examiner's inspection any substantiating documents relating to the claims.

Losses from
fire, floods,
etc.

Insurance charges are usually found in a special account or in the general expense account, and may be recorded by one of the following methods:

Insurance.

(1) *Expense of the Year*.—The total amount paid for insurance may be charged as an expense of the year and may constitute premiums paid in advance covering several years, usually three for fire insurance. Such payments, unless for insurance of a kind specifically excepted by the Regulations, are allowable deductions only to the extent of the premiums covering insurance of the taxable year, if the system of accounting employed is not that of cash receipts and disbursements.

(2) *Prorated to Years*.—The charges for insurance may be prorated to the years to which they belong by charging the payments for premiums to an "insurance paid in advance" account and transferring from this account periodically the amounts of the expired premiums to the insurance (expense) account.

The taxpayer may not deduct from his gross income, premiums paid on life insurance policies covering the lives of officers, employees

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or those financially interested in any trade or business conducted by the taxpayer, except when such premiums are paid purely as reasonable additional compensation to the employee, in which case the employee is required to report such premiums as income in his own return.

A creditor may deduct as an expense the amount of premiums paid for life insurance taken out by him to cover loans to the debtor, but the premium will cease as an allowable deduction upon maturity of the loan.

Legal expenses.

The taxpayer should note that organization expenses are not deductible as legal or other expense. The total amount paid for legal expense is usually shown in a special account, but sometimes is included in the general expense account. Large fees, which appear to be excessive, will call for an investigation on the part of the examiner, unless proper data and explanations are at hand. Legal expense with respect to the taking out of patents or copyrights may, at the option of the taxpayer, be capitalized as cost of patents or copyrights, or taken as a deduction.

Additions and betterments of leased property.

Expenditures for additions and betterments on leased property should be prorated over the life of the lease. They should not be charged in total as a deduction from the income of the year in which they were made, as only that portion of the expenditures applicable to the taxable year may be deducted. In case the life of

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the addition or betterment is less than the life of the lease, such addition or betterment should not be prorated over the duration of the lease, but over the life of the betterment itself. (See Treasury Decision 2442.) In accordance with a recent court decision, buildings or improvements erected on leased property are income to the lessor at the date of completion, if such buildings or improvements are not subject to removal by the lessee, to the extent of the fair market value of such buildings or improvements with due regard to the terms of the lease. The net income in such a case is ordinarily arrived at by taking the difference between the value of the land free from lease without such improvements, and the value of the land subject to the lease with such improvements. If the lease is subsequently terminated for any reason other than the purchase of the lease by the lessor so that the lessor comes into possession and control of the property prior to the time originally fixed for the termination of the lease, the lessor receives taxable income for the year in which the lease was so terminated to the extent of the difference between the fair market value of such buildings and improvements at that time and the fair market value of the buildings and improvements subject to the lease when title passed to the lessor and such property became part of the realty.

The ordinary expenses of salesmen or em-

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Traveling expenses.

ployees while traveling for the company may be taken as a deduction from income by the taxpayer, provided the amount claimed represents money spent and not balances in the hands of the travelers. Instances are rare where directors or other officers of a company have, under the guise of traveling expenses, received a share of the profits or compensation, but in the event any large items appear among these charges, the taxpayer should be in a position to explain them satisfactorily to the examiner. It is advisable, when possible, to have signed receipts and vouchers supporting expenditures of this nature.

Payments for damages.

Losses arising out of payments for damages are limited to transactions closed in the taxable year. The taxpayer should substantiate his claims for loss, especially when they result from litigation, by documentary evidence for the examiner's inspection.

Loss on sale of assets.

A taxpayer who claims loss from the sale of assets purchased prior to March 1, 1913, should ascertain the value as of that date of the assets sold and present the data with respect to the loss in a manner similar to that used where such a sale results in income.

Retirement of bonds.

Under certain conditions, the regulations permit a corporation in its return to treat as a deduction losses resulting from the purchase of its own bonds at a price above par. Before making this deduction, a taxpayer should read very

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carefully the regulations relating to this subject, which are found in Articles 152 and 153, Regulations 33 Revised, and Articles 544, 563 and 848, Regulations 45 Revised.

The allowance for depreciation is based upon the cost of the depreciable property in question to the taxpayer (or the March 1, 1913, value of such property in the event that it was acquired prior to this date) and the estimated life of the property. There is no particular method prescribed by the Bureau of Internal Revenue which must be followed in computing the depreciation allowance. The usual practice of taxpayers, however, has been to follow the "straight line" method of depreciation, that is, the cost or March 1, 1913, value of the property, less its salvage value is written off in equal annual installments. Where depreciable property is acquired by a corporation by the issue of its capital stock, the sum upon which depreciation is to be based is the fair market value of the property at the date of acquisition, or the March 1, 1913, value of such property if acquired prior to March 1, 1913. Taxpayers are permitted under certain circumstances to revise their rates of depreciation. Where such a revision is made the taxpayer should be prepared to give full explanation of the reasons therefor to the Bureau or its representatives.

There will be instances when an Agent will think that a taxpayer has used rates that are

Depreciation.

Factors affecting rates.

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excessive in view of the nature of the property. If such a situation arises, the taxpayer should furnish the examiner with his reasons for the belief that his property is subject to abnormal depreciation. Some of the conditions under which abnormal depreciation may result and an abnormal rate be claimed are the following:

(1) If the taxpayer has machinery which he is operating for a period longer than the normal running time, as, for example, a machine shop which he is operating three shifts of eight hours each—that is, running his machinery continuously—an abnormal rate of depreciation would result.

(2) If the class of artisan, mechanic or operator of the machinery is considerably below standard, an abnormal rate of depreciation may exist on account of the lack of care exercised by the operator.

(3) Special climatic conditions may be causes of abnormal depreciation.

In some cases a taxpayer may take a larger deduction for depreciation in 1918 than in previous years, because of the fact that Section 214 of the Revenue Act of 1918 allows as a proper deduction “a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.” Obsolescence prior to 1918 was not allowed as a deduction.

Each taxpayer is usually a good judge as to the life of his property and the amount of depreciation that should be charged off, and the

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examiner gives due consideration to the views of the taxpayer in this matter.

Depreciation allowances may be deducted on both tangible and intangible property which gradually approaches a point where its usefulness in the trade or business is exhausted. The allowance is restricted to property used in the trade or business; therefore depreciation on buildings and furniture or fixtures used by a taxpayer solely for his personal use is not allowable as a deduction.

Fluctuations in the market value of property are not allowed to be taken as depreciation deductions from gross income. Such fluctuations may result in losses when realized upon the sale, abandonment, or other disposition of the property.

There are certain expenditures such as for designing, drawings, patterns and experimental work which may at the option of the taxpayers be taken as deductions from gross income for the taxable year in which they are incurred, or they may be capitalized. If the period of usefulness of any such asset may be estimated with reasonable accuracy, depreciation allowances may be spread over such estimated period subject to the approval of the Commissioner. It is also optional with the taxpayer subject to the approval of the Commissioner whether the cost or value of mining property, including plant and equipment, ores

**Taxpayers'
options.**

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and minerals and additions to capital account not charged to expense, shall be recovered at a rate established by current exhaustion of mineral, or whether the cost and value of the mineral and charges to capital account of expenditures, other than for physical property, shall be recovered by appropriate charges based on depletion and the cost or value of plant and equipment be recovered by reasonable charges for depreciation after taking into consideration salvage value.

In cases where taxpayers have acquired properties such as plant, equipment, etc., and have never taken depreciation into account, but in lieu thereof have charged off to expense additions, betterments and replacements, there should be taken into consideration among other factors the operating efficiency of the plant during the taxable year in arriving at an equitable amount of depreciation to be written off for prior years, in determining the adjustment to be made for invested capital purposes.

Deprecia-
tion of in-
tangibles.

Where the use of intangibles in a trade or business is definitely limited in duration, they may be subject to depreciation. Patents, copyrights, licenses, franchises, etc., may or may not be depreciated at the option of the taxpayer, but whichever method is adopted by the taxpayer must be followed consistently. An intangible asset, the life of which is not definitely

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limited, is not subject to a depreciation allowance.

In computing a depreciation allowance in the case of a patent or copyright, the amount subject to depreciation is the cost, or the fair market value as of March 1, 1913, if acquired prior thereto. **Patents or copyrights.**

If the patent or copyright was acquired by the taxpayer from the Government, its cost is made up of the various Government fees, cost of drawings, experimental models, attorneys' fees, etc. If the patents or copyrights were acquired for stock of the corporation, the cash value at date of acquisition if acquired after March 1, 1913, would be the amount subject to depreciation. Depreciation of a patent or copyright, if acquired prior to March 1, 1913, can be taken on the fair market value as of March 1, 1913, only when the claim is properly supported by adequate proof of cash value as of March 1, 1913.

Taxpayers quite often fail to distinguish between OBSOLESCENCE and OBSOLETENESS.

Obsolescence is the act of becoming obsolete due to normal progress of the art or to the property in question becoming inadequate to the growing needs of the business so that such property will in due course have to be discarded or abandoned before the expiration of its ordinarily useful life. **Obsolescence.**

Obsolescence is the state of being obsolete and **Obsolescence.**

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exists when the particular property has been abandoned or discarded because of some change in business conditions on account of which the usefulness of the property in the business is suddenly terminated. Obsolescence is covered in Article 143 of Regulations 45 under the general caption of "Loss of Useful Value."

Obsolescence, or loss of useful value, was permitted as a deduction from gross income under each of the several Federal income tax laws. Obsolescence, however, was for the first time permitted to be taken into consideration as a deduction from gross income under the Revenue Act of 1918 and applies to 1918 and subsequent years.

A taxpayer having suffered a loss of useful value (Art. 143) is allowed to deduct only that amount representing the cost, or March 1, 1913, value, of the property less subsequent depreciation claimed, less the residual value. If property is disposed of, a taxpayer should retain such data as relate to the sale, for the inspection of the Bureau.

In regard to obsolescence of buildings for the years 1918, 1919, 1920, the following article on depreciation and obsolescence in Bulletin F, issued by the Bureau of Internal Revenue, makes clear the exact manner in which the loss should be treated:

"Obsolescence of Buildings.—No amount may be charged off in any year in anticipation of obsolescence

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of a building which may become obsolete a number of years later. A certain amount of obsolescence may, however, be claimed from the time it becomes certain that at a definite future date the building will be obsolete. The figure representing obsolescence shall be approximately the difference between the fair market value of the building as at March 1, 1913, or its cost if acquired on or after that date, less depreciation and the estimated salvage value. This obsolescence should be spread over the period from the time such obsolescence becomes certain until the building becomes obsolete, and should be claimed in the returns filed for those years. In cases where obsolescence is claimed, it must be supported by a statement sufficient to establish the facts upon which it is based."

Obsolescence in the case of intangibles is not ordinarily an allowable deduction, but in exceptional cases such as the discontinuance of a going business because of the elimination of its market through adverse legislation or similar circumstances the cost (or March 1, 1913, value if acquired prior to this date) of such assets as goodwill, trade-marks, or trade brands may be deducted within certain definite limitations in computing taxable net income.

In order to sustain a claim for the obsolescence of goodwill it must be shown that the taxpayer will be forced to discontinue his present business, that he will be unable to continue in another similar business, and that the goodwill will be of no value at the close of an ap-

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proximately definite period. The cost of the goodwill or its market value as of March 1, 1913, if acquired prior to that date, must be definitely shown. It must also be definitely proven to the Commissioner's satisfaction that the goodwill will not be valuable in another business after the termination of the business in which the taxpayer is engaged.

Brewers, distillers and liquor dealers whose property has been impaired in value by prohibition legislation may establish a claim for obsolescence of their intangibles by the sale of the business or by evidence other than the actual sale of their obsolete property.

Depletion.

It is important that a taxpayer claiming deductions for depletion should support the reasonableness of his claim and the basis of the rate used by such technical references as may have been used in his computations. Engineering, geological or other like data should be presented as evidence to support the deduction claimed. The taxpayer might make inquiries as to the usual and ordinary rates of depletion applicable to the class of properties operated in the same territory. He should not change his rate of depletion without technical evidence of engineers, geologists or other experts qualified to give reliable estimates.

Operating owners, lessors and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion, but

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a stockholder in a mining or oil or gas corporation is not allowed such deduction on the corporate property.

Under the Revenue Act of 1918 an operating owner in fee may base his depletion deduction on the cost or value of the property at "date of valuation," or "basic date" (i. e., March 1, 1913, in the case of property acquired prior thereto, the date of acquisition in the case of property acquired on or after March 1, 1913, or the date of discovery or within thirty days thereafter in the case of discovery after March 1, 1913), plus subsequent allowable capital additions, minus the value of the land at the basic date for purposes other than for mineral production, and minus the value of the properties at the basic date subject to depreciation allowances.

In case of
lessor.

Under the Revenue Act of 1918 a lessee may base his depletion deduction on the value, as of the basic date, of the lessee's equity in the property, plus subsequent allowable capital additions, minus the value of the assets at date of valuation subject to depreciation allowance, or subject to neither depreciation nor depletion allowances. The combined value of the equities of lessor and lessee when determined as of the basic date, although computed separately, may not exceed the value at that date of the property in fee simple. The value of a lessee's equity at the basic date is as follows:

In case of
lessee.

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- (a) If acquired prior to March 1, 1913, the lessee's equity is the value of his interest in the mineral deposit as of that date.
- (b) If acquired after March 1, 1913, in a proven mineral property, the lessee's equity is its cost.
- (c) In the case of a discovery on or after March 1, 1913, the lessee's equity is the fair market value, at date of discovery or within thirty days thereafter, of his equity in the mineral discovered.

Valuation of lessor's equity.

A lessor although originally owner in fee may take a deduction for depletion only to the extent of the value of the lessor's equity under the terms of the lease, which equity is valued as follows:

- (a) In the case of a mineral property not under lease on March 1, 1913, but subsequently leased, the lessor's equity is the *en bloc* value of the mineral in the ground on March 1, 1913, and in the absence of satisfactory evidence to the contrary, his equity is presumed not to exceed the value as of March 1, 1913, of the royalties to be expected under the lease.
- (b) In the case of a mineral property under lease March 1, 1913, for the entire operating life of the mineral deposits, the lessor's equity is the value as of March 1, 1913, of the royalties and other payments to be expected under the terms of the lease in effect on that date.

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- (c) In the case of a mineral property under lease for a portion of its operating life, the lessor's equity is the value as of March 1, 1913, of the royalties expected from the mineral to be extracted during the life of the existing lease, plus the estimated *en bloc* value of the mineral remaining at its expiration, which, in the absence of satisfactory evidence to the contrary, is presumed not to exceed the value as of March 1, 1913, of royalties which could have been expected as at that date from the remaining mineral.
- (d) In the case of a mineral property acquired after March 1, 1913, the lessor's equity is its cost.
- (e) In the case of a discovery on or after March 1, 1913, the lessor's equity is the fair market value, at the date of discovery or within thirty days thereafter, of his equity in the mineral discovered.

The valuation of mining properties for depletion purposes, it should be noted, whether in the case of owner in fee, lessor or lessee, is based upon the determination of cost or fair market value of the mineral properties at certain dates.

The determination of cost must be supported by evidence to show that the price at which the property was bought was the result of a *bona-fide* purchase, as no fictitious or inflated price will be allowed as a basis for the depletion computation, and in order to determine whether the

Sale to establish values must be bona fide.

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price paid represented the actual market value of the property any affiliation existing between the vendor of the property and the vendee will be taken into consideration.

**Evidence
of different
kinds.**

The determination of the fair market value of mineral properties at a specified date as a basis for depletion should represent the consideration a willing buyer would pay a willing seller as at that particular date. The Commissioner will take into consideration any evidence having a bearing on the market value, such as—

- (a) Actual cash offers.
- (b) Actual sales and transfers of similar properties.
- (c) Market value of stock issued therefor.
- (d) Royalties and rentals.
- (e) Value fixed by owner for capital stock tax.
- (f) Valuation for local or state tax.
- (g) Records of litigation in which value of property was in question.
- (h) Disinterested appraisals by approved methods such as the present value method, etc.

**Valuations
accepted by
Bureau may
not be
changed.**

When once the value of mineral deposits has been determined and accepted by the Bureau, no revaluation of the properties will be allowed during the continuance of the ownership under which the value was so determined, except in the case of a discovery or a virtual change of ownership of part of the property as the result of litigation or outright sale. However, a new unit value for depletion may be established in

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the case of a revision of the number of units of mineral in the property, in which case proof of such mineral content, to the satisfaction of the Commissioner, must be submitted.

A taxpayer who includes in the valuation of his property for the purpose of depletion the value brought about as a result of discoveries after March 1, 1913, must show that the fair market value of the property at the date of discovery or within thirty days thereafter is disproportionate to the cost. That is, that the new discoveries contain resources in such quantity and of such quality as to reasonably warrant the expectation of the return of an amount materially in excess of the cost of making the discovery, plus the cost of future development, exploration and equipment.

Valuation
based on
discovery.

The peculiar conditions relative to the discovery in each individual case are considered in determining the valuation to which the taxpayer is entitled. A discovery is disclosed by drilling or exploration above or below ground, showing the location of deposits not previously known to exist, and not included in any previous valuation for the purpose of depletion. The value of the property claimed as a result of discovery must be the fair market value determined on the same basis as outlined in the foregoing paragraphs. The taxpayer will be required to submit full details relative to the circumstances of the discovery, such as

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the size, character and location of the discovered deposit and the cost of the discovery and its development.

Calculation
of
depletion.

After the value of the deposits has been determined to the satisfaction of the Commissioner, depletion for the taxable year may be computed by dividing the value ascertained by the number of units believed to exist at the basic date and by multiplying the resultant unit value by the number of units sold within the taxable year. For instance, in the case of a coal mine which was purchased in January, 1916, by a corporation for \$50,000, the estimated total content of the mine at date of purchase being 100,000 tons and during the taxable year 1920 two thousand tons having been excavated and sold, the depletion deduction allowable for the 1920 return is computed as follows, assuming that the land acquired had no value for purposes other than mining:

$$\begin{array}{l} \$50,000 \div 100,000 = 50 \text{ cents per ton} \\ 2,000 \times 50 \text{ cents} = \$1,000, \text{—depletion deduction allowable.} \end{array}$$

In the case of a lessee or lessor, royalty vouchers may be used as evidence to substantiate the output of mines.

Valuation
an engi-
neering
problem.

The determination of the number of units in the mineral deposit at the basic date in the case of mines is strictly an engineering problem. The evidence submitted to the Bureau must be in such form that it can be readily verified by

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the Government engineers. An estimate will have to be made with respect to each separate property, showing the total units (tons, pounds, ounces or other measure of mineral products) reasonably known or on good evidence believed to have existed in the ground on the date of acquisition or valuation. The estimate may include the ores and minerals in sight, "blocked out," "developed," or "assured" according to the type of the deposit, and "probable" or "prospective" ores and minerals only to the extent that their existence is indicated by geological or other evidence. **Mines.**

In the case of oil fields, the oil reserves must be estimated for unproven land as well as for producing land and in the event that subsequent information shows the estimate to be erroneous it may be revised with the approval of the Commissioner. **Oil fields.**

In the case of gas wells the depletion allowance may be computed by the method most suitable to the particular case in question owing to the peculiar conditions surrounding the production of natural gas. Usually, however, the depletion of natural gas should be computed on the basis of decline in closed or rock pressure, taking into account the effects of water encroachments and other factors. Whatever method is adopted must be acceptable to the Commissioner. **Gas wells.**

Depletion may also be taken on timber tracts, **Timber tracts.**

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based upon the fair market value of stumpage as of March 1, 1913, if acquired prior to that date, or cost at date of acquisition if acquired subsequently. The method of computing timber depletion is similar to that outlined for mineral deposits.

Interest as
a deduction.

The 1917 and 1918 regulations differ as to the amount of interest allowable as a deduction for income tax purposes. As previously stated, Article 180, Regulations 33 Revised, explains the statutory limitation on the amount of interest that could be deducted prior to 1918, while Article 121, Regulations 45, allows as a deduction for 1918 and subsequent years all interest paid or accrued within the year on indebtedness, with the exception of interest incurred or continued to purchase or carry securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is exempt from income tax.

Limitation
under 1917
revenue
act.

Item 2 on the face of the 1917 income tax return should reconcile with the outstanding indebtedness as shown by the balance sheet at the end of the year. This item must not include any indebtedness wholly secured by collateral subject to sale or hypothecation in the ordinary business of the company, nor any indebtedness incurred in the purchase of securities the income from which is not taxable. Article 183 of Regulations 33 specifically sets forth the manner in which the limitation of interest may be

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computed for the taxable year 1917 where it is paid at different rates. At no time during the taxable year 1917 may interest be taken as a deduction on an amount of indebtedness in excess of the outstanding capital stock at the close of the year, plus one-half of the interest-bearing indebtedness also then outstanding. For the purpose of determining the deduction for interest allowable, the par value of the paid-up capital stock outstanding at the end of the year is used. When no-par-value stock has been issued, the taxpayer must consider the cash value (at date of payment) of the consideration paid in for stock as the amount of the outstanding capital stock. Unissued stock or treasury stock which has been issued for value and later repossessed by the corporation is not to be included. Revenue Agents sometimes question officers of corporations to verify the full payment on stock, owing to the fact that in rare cases it has been brought to light that the stock which appeared to be issued for cash was not fully paid for.

In cases where the company has outstanding so-called certificates of indebtedness or income sinking fund certificates which are in reality preferred stock, the interest paid thereon must be considered as a dividend, and is not allowable as a deduction from gross income, but such certificates may be included in invested capital.

Interest paid on indebtedness secured by col-

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lateral, which is the subject of sale or hypothecation in the corporation's ordinary course of business as a dealer in such property, is deductible on an amount of indebtedness not exceeding the actual value of this collateral. A taxpayer will usually find there is no limit upon the amount of deductible interest in this class, as the amount of indebtedness is almost always less than the actual value of the collateral.

The amount claimed as a deduction should actually have been paid or accrued and should be consistent with the rate and total amount of the indebtedness.

Taxes.

In determining taxable net income for the years subsequent to 1916, a taxpayer should not deduct amounts paid for Federal income or profits taxes, as such taxes are deductible only if paid or accrued prior to January 1, 1917. State taxes paid by a bank on its capital stock on behalf of its stockholders are not deductible by the bank. Other nondeductible taxes are assessments for local improvements and similar special levies.

Additional excise tax assessed against a corporation under the Act of August 5, 1909, and paid during subsequent years is an allowable deduction from gross income reported in the corporation return for the year in which paid.

A corporation keeping its accounts on an accrual basis may accrue the capital stock tax, State tax, import or tariff duties, stamp taxes,

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and local taxes, other than for local benefits, for the purpose of computing taxable net income and deduct the taxes thus accrued from gross income of the year to which they apply. If the accounts are kept on the receipts and disbursements basis, such taxes should be deducted from gross income for the year in which paid.

Taxes imposed by a foreign country, other than assessments against local benefits, are deductible from gross income, except foreign income, war profits and excess profits taxes which are allowed as a credit against the Federal income and profits taxes of domestic corporations for the taxable year 1918 and subsequent years. In order to secure such a credit, a domestic corporation must file form 1118; if the taxes for which credit is sought have been paid, there must be attached to form 1118 the receipt for each such tax payment. When the foreign tax for which credit is claimed has been accrued but not paid, a copy of the return on which each such accrued tax was based must be attached to the form.

A domestic corporation which owns a majority of the voting stock of a foreign corporation during 1918 and subsequent years, is entitled to credit its own Federal income and profits taxes with the income, war profits and excess profit taxes actually paid within the taxable year, but not including taxes accrued by such foreign corporation, to any foreign coun-

Foreign taxes.

Foreign income taxes credit against Federal taxes due.

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try or possession of the United States, upon income derived from sources without the United States in an amount equal to the proportion which the dividends (not deductible under Section 234) received by such domestic corporation, from such foreign corporation during the taxable year bear to the net income on account of which such taxes were paid, but not in excess of the dividends so received.

It should, therefore, be noted that a domestic corporation having foreign branches not incorporated may claim as a credit the entire income, war profits or excess profits taxes accrued or paid to a foreign government, whereas domestic corporations with foreign branches which have been incorporated and have become foreign subsidiaries may claim as a credit taxes actually paid in the taxable year but limited in amount in the manner prescribed in the preceding paragraph.

Amortiza-
tion of war
facilities.

A taxpayer may take as a deduction for the taxable year 1918 and subsequent years the amortization of such part of the cost of facilities constructed, erected, installed or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war and of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the war, as has been borne by the taxpayer. In the case of such property the con-

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struction of which was commenced before April 6, 1917, and completed after that date, amortization will be allowed only on that portion of the cost incurred on or after April 6, 1917.

Many taxpayers have taken amortization deductions on their income tax returns for the taxable years 1916 and 1917, because they were allowed to amortize certain of their plants and machinery under the Munitions Tax Act of 1916. The Income Tax Acts of 1916 and 1917 have no relation whatsoever to the Munitions Tax Act and as the Income Tax Acts of 1916 and 1917 did not provide for amortization of any kind these claims have been disallowed by the Bureau in determining net income for income tax purposes.

**Amortiza-
tion for 1916
and 1917
permitted
only for
Munitions
Tax pur-
poses.**

The amortization provision in the Revenue Act of 1918 is designed solely to meet the conditions resulting from the war. In some instances entire new industries had been created and old ones expanded abnormally so that at the termination of hostilities it was thought some plants would become entirely useless while others could utilize only part of their capacity. Under Article 184, Regulations 45, as amended, the cost of facilities and vessels coming under the amortization provision of the 1918 Act were divided into the following two classes:

**Purposes of
Amortiza-
tion in 1918
Act.**

(1) In the case of property useful to the taxpayer only during the period of its operation as a war facil-

**Two classes
of Amorti-
zation.**

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(1) Property permanently discarded.

ity and which has been sold or permanently discarded within three years after the termination of the war, the amortization deduction allowed is the difference between the depreciated cost as of January 1, 1918 (if acquired prior to that date), or actual cost (if acquired subsequent to January 1, 1918), and the actual sale price or estimated fair market value as of the date when the property was or will be permanently discarded, such fair market value to be re-established at and as of the time of the investigation by engineers of the Bureau of Internal Revenue.

(2) Property continued in use.

(2) In the case of property not included in class (1) above, the amortization deduction is the difference between the cost of the facility depreciated as of January 1, 1918 (if acquired prior to that date), or actual cost (if acquired subsequent to January 1, 1918), and the estimated value to the taxpayer in terms of its actual use or employment in his going business, such value to be not less than the sale or salvage value of the property, and provided, however, that for the purposes of returns made in 1919, the preliminary estimate of the amount of such amortization shall not in any case have exceeded 25 per cent of the cost of the property. In the determination by engineers of the Bureau of Internal Revenue of the proper amortization allowance, the estimated value to the taxpayer of the property in terms of its actual use or employment in his going business shall be as of the time of such determination. In the final determination, the amount of the amortization allowance will be ascertained upon the basis of stable post-war conditions under regulations to be promulgated when these conditions become apparent.

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The Bureau, in amending Article 184, has changed the basis of determining the amortization allowance of Class 2 property from "the estimated reproductive cost as of April, 1919," to the estimated value of the property to the taxpayer in terms of its actual use or employment in his going business, determined upon the basis of stable post-war conditions. The original basis failed to take into consideration the duration of the period of transition from a war basis to a peace basis. In many instances war contracts were not canceled with the signing of the armistice but the work was continued upon them far into 1920 and in a few cases plants are even now working on war contracts, so that the above amended regulation rectifies a procedure which would have been decidedly unjust.

It can be readily seen that the second classification is the most difficult to determine, as the fluctuations in price levels constantly change the basis of computation. Section 214(a) provides that a redetermination of the amortization allowance at any time within three years after the termination of the war may be made by the Commissioner at his option, or at the request of the taxpayer if it is found by an appraisal or other evidence that the deduction originally allowed was incorrect. Taxpayers need not await the formal termination of the war but may present their claim to the Com-

Redeter-
mination of
amortiza-
tion pro-
vided for.

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missioner for a redetermination at any time prior to three years after such termination.

Penalties
for
negligence.

In cases where excessive amortization deductions have been taken by a taxpayer on his returns he will be subject to a 5 per cent penalty (Art. 1005) and interest (Art. 1003) for negligence. It is therefore advisable for a taxpayer to file an amended return for the taxable years 1918 and 1919 if more than 25 per cent of the cost of the property was taken as a deduction in 1918. The Bureau has held, however, in the event that a case is reopened within a period of three years after the termination of the war and an additional amount of amortization allowed, that the penalty and interest should attach only to such amount of tax as upon final settlement is found to have been due the Government and not paid at the time of filing the return by reason of the taxpayer's ignoring the regulations.

Amended
returns may
be filed.

Although the preliminary estimate of amortization on property coming under Class 2 is limited to 25 per cent of the cost of the property, and should be so reported on the original returns by the taxpayer and the tax should be paid on that basis, in order to make sure he will not be subjected to the negligence penalty, plus interest, amended returns may be filed for amortization on Class 2 facilities, claiming the full amount which in the judgment of the taxpayer is a reasonable estimate of the total de-

TAXABLE NET INCOME

crease in value of the facilities. Such a claim must be fully supported by adequate proof of value. The preliminary estimate of 25 per cent of the cost of such property is not intended to represent a fixed and final limitation on amortization deductions, but is merely to protect the Government from the extravagant claims of certain taxpayers who purposely report a small tax due in order to have the use of the money due the Government as working capital until their returns are finally examined, which in some instances covers a period of two years or more.

In determining the amount of amortization to be claimed upon Class 2 facilities when the entire plant or part of the plant is to be utilized for production in post-war work, it is necessary to ascertain the difference between the depreciated cost of the plant as of January 1, 1918, or if acquired subsequently to that date the actual cost, and the saleable value of the plant or its "value in use," whichever is higher. For instance: If a manufacturer had equipped his plant, January 1, 1918, with 900-ton presses to turn out forgings for 12-inch shells and it was found that in his post-war operations 500-ton presses were sufficiently large to turn out his work, if he continues to use the 900-ton presses the "value in use" of those presses to him is the amount he would be compelled to pay for an equivalent number of 500-ton presses.

Illustration amortization in Class 2.

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If the saleable value of the 900-ton presses is less than the amount representing their "value in use," then his amortization claim will be the difference between the original cost of the 900-ton presses and the amount representing their "value in use." On the other hand, if the saleable value of the 900-ton presses is greater than their "value in use" then he can claim amortization only on the difference between the original cost of the 900-ton presses and the saleable value of the presses.

Allocation
of amorti-
zation
allowance.

Article 185, Regulations 45, outlines the method by which the amortization allowance is to be spread over the taxable periods under consideration. The allowance for amortization is to be apportioned on the basis of the net income (computed without benefit of the amortization allowance) between January 1, 1918 (or if acquired in a subsequent year, January 1 of the year in which acquired), and the following dates:

(a) If the claim is based on subdivision (1) of Article 184, the date when the property was or will be sold or permanently discarded as a war facility. (b) If the claim is based on subdivision (2) of Article 184, the actual or estimated date of cessation of operations as a war facility.

For example, if Corporation X discarded its war facilities on June 1, 1919, the amortization allowance would then be allocated to the tax-

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able years 1918 and 1919 in accordance with provision (a) above, as the claim comes under Class 1 of Article 184. Assuming that the earnings of Corporation X for the year 1918 were \$75,000 and earnings up to June 1, 1919, were \$25,000, on the basis of the above earnings the amortization allowance would be prorated 75 per cent to 1918 and 25 per cent to 1919. In the case of facilities coming under the provisions of Class 2, Article 184, after estimating the date of cessation of operation as war facilities, the amortization allowance would be allocated to the years included in the amortization period on the basis of earnings or estimated earnings received or expected to be received during each year within the period using the same method of apportionment as illustrated above.

Illustration

Article 185 provides that the amortization allowance shall be spread in proportion to the net income (computed without the benefit of the amortization allowance) between January 1, 1918, or the date of acquisition of the property if acquired subsequent to that date, and the date of cessation of operation as a war facility. However, it appears to be a more equitable basis to spread the amortization allowance on such facilities over the taxable years affected on the basis of the net income derived from the use of such war facilities.

Summarizing the requirements, briefly, there

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Three factors in preparation of claim.

are three factors that must be determined in preparing a claim for amortization:

- (a) The total amount of amortization allowable as a deduction.
- (b) The period covered by amortization depending upon the subdivision of Article 184 under which the property is classified.
- (c) The basis upon which the amortization allowance is to be spread over the amortization period.

Reconciliation of net income per books with taxable net income.

The taxpayer will find that a complete analysis of the profit and loss and surplus accounts for the taxable year will greatly facilitate the preparation of the statement reconciling the net profit per books with the taxable net income. If the taxpayer maintains a well-kept set of books, he will have no difficulty in making this analysis. The surplus should be analyzed first. Beginning at the opening date under review, a list should be prepared of all the main credits in one column and main debits in another, without attempting a detailed analysis of all the numerous small debits and credits which may be combined. A careful check should be made of important items of large amount. The analysis will probably cover such items as the balance transferred from the profit and loss account, amount of dividends paid, adjustments of book values of plant or prop-

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erty, and other items which are vital to the taxpayer's making a proper return.

An analysis should also be made of the profit and loss account which may reflect on the credit side such gains or profits as bad debts recovered, forgiven debts, earnings of subsidiaries, profits on sales of capital assets, adjustments for excessive depreciation reserve, etc. Some of the debits which would represent losses or expenses to be returned as deductions might be made up of such items as losses from the sale of capital assets; obsolescence of machinery, drawings, patterns, models and similar property; depreciation of machinery, buildings, etc.; losses from fire, flood, wind, explosion, shipwreck, or theft; amortization of discount on bonds; payments for damages; premium on bonds retired, etc.

**Analysis
of Profit
and Loss
Account.**

It would be advisable to verify the balances transferred by the closing entries from the various sales, expense or other operating accounts and see that they agree with the amounts recorded in the profit and loss account.

The non-taxable income, such as interest on obligations of the United States wholly exempt, interest on Farm Loan bonds, dividends on stock of domestic corporations, etc., should be segregated from other gross income and listed separately.

The unallowable deductions, such as donations, additions to reserves for bad debts, con-

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tingencies, etc., should be segregated from the other debit items and also placed in a separate list, so that in the preparation of the return, items of the above nature will not be included as deductions.

Excessive deductions.

Deductions on returns in excess of deductions shown on a taxpayer's books are, on their face, erroneous, as the principle is consistently set forth in Treasury decisions and in regulations that deductions must be entered in the books. There are often cases where books that are incorrectly kept bring about this situation. All such differences should be adjusted without delay. If the deductions are in accordance with the law and regulations and the taxpayer makes the necessary additional entries, the examiner will usually approve them.

Penalties

In this connection the taxpayer's attention is directed to the penalties which are imposed for the taxable year 1918 and subsequent years for fraud or negligence in the preparation of returns. In order to avoid such penalties, an amended return should be filed immediately, if erroneous deductions have been claimed.

CHAPTER IV

PERTAINING TO PROFITS TAX RETURNS

1. Invested Capital—2. Surplus—3. Adjustments to Capital and Surplus by Way of Additions or Deductions—4. Changes in Invested Capital during Taxable Year—5. Deduction from Net Income to Determine Amount Subject to Profits Tax—6. Balance Sheets

THE excess profits tax law of October 3, 1917, levied a tax known as the war excess profits tax upon the net income in excess of certain exemptions on all individuals, partnerships and corporations engaged in business or trade. This tax is not limited merely to income derived from war industries but is levied against gains, profits and income derived from any source whatever unless exempt from tax by law. The war was the cause that necessitated the above levy but was not necessarily the occasion for the income subject to tax.

General
remarks.

There are two bases for the application of the tax:

In the case of trades or businesses, whether conducted by individuals, partnerships or corporations, in which the income is derived primarily from the use of capital, the net income in excess of specified deductions and exemptions is subject to graduated rates of tax depending on the relation of the net income to

Invested
capital.

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certain percentages of what is known as invested capital.

Nominal capital.

In the case of a taxpayer whose trade or business has "no invested capital or not more than a nominal capital," the excess profits tax is 8 per cent of so much of the net income subject to excess profits tax as exceeds \$3,000 for corporations, and \$6,000 for individuals or partnerships.

Special cases.

Section 210 of the excess profits tax law authorizes the Secretary of the Treasury, in cases where invested capital cannot be determined satisfactorily, to set up constructive invested capital based upon actual invested capital found to be employed in representative concerns engaged in a "like or similar trade or business."

Revenue Act of 1918.

Under the Revenue Act of 1918, the war profits and excess profits tax, like the income tax, is a tax upon net income, but applies only to corporations. This tax is imposed upon the net income of every domestic corporation, except certain specifically exempted ones, and on every foreign corporation having net income from sources within the United States.

Certain provisions of the statute specify special features with respect to the computation of the tax of the following classes of corporations: (a) Corporations deriving net income from Government contracts, Section 1, (b) transportation corporations, Article 504, Regulations 45,

PROFITS TAX RETURNS

(*c*) corporations partaking of the nature of personal service corporations, Section 200, (*d*) corporations engaged in the mining of gold, Section 304, (*e*) foreign and other "special" corporations as outlined in Section 327, (*f*) reorganized companies, Sections 330 and 331, (*g*) corporations making their return upon the basis of a fiscal year, Section 335, (*h*) corporations which have sold mines, or oil or gas wells, Section 337, and (*i*) affiliated corporations, Section 240.

1. Invested Capital

In most returns for corporation taxes in the year 1917, or subsequent years, the chief item to which consideration must be given is the determination of invested capital. The War Revenue Act defines invested capital as being the amount of cash and other assets (subject to certain limitations) paid into the corporation for stock, plus the paid-in or earned surplus and undivided profits, (but not including earnings or profits of the taxable year.)

The starting point for the computation of invested capital is the amount of cash or other property actually paid in. The invested capital values of the various kinds of such property paid in are determined for the purpose of the 1917 Act by Articles 55, 56 and 57 of Regulations 41, concerning tangible property, patents and copyrights, and intangible property

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respectively. In 1918 and subsequent years, the invested capital values of property paid in to the corporation are determined in accordance with Articles 833 to 836, inclusive, and 851, Regulations 45, concerning tangible and intangible property, respectively.

Computation of invested capital, however, does not stop at this point, but as stated in Article 42, Regulations 41, "it must take properly into account the surplus and undivided profits." In many cases the surplus and undivided profits as shown on the balance sheets of a corporation are not the true figures, so examiners usually make a detailed analysis of the surplus account, frequently finding that appreciation of a kind not permitted by the regulations has been included therein. Provision for depreciation, depletion or obsolescence is sometimes neglected by a taxpayer, or he has overestimated these items, and the examiner accordingly makes the necessary adjustments. Frequently he has to disallow items which are excluded from invested capital by the regulations, or allow items which through error have not been taken into consideration by the taxpayer.

History of
the concern.

In many instances it is necessary to be familiar with the complete history of a concern before the correct invested capital can be arrived at. The history of most concerns will be found in the minute books, capital stock records, journal entries, diaries, day books or memoran-

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dum books and such publications as Moody's and Poor's Manuals. Facts with respect to the origin, capitalization, affiliations and especially any reorganization of the concern have an important bearing on invested capital. The entries affecting invested capital should be strictly in accordance with the terms of organization or reorganization agreements, otherwise the invested capital will have to be adjusted to correspond to the actual facts in each case.

For the correct determination of invested capital, an analysis of the capital stock account is necessary. This analysis should show the capital stock accounts from the inception of the business to the close of the taxable year of the corporation, disclosing the following:

**Analysis
capital stock
account.**

- (a) Whether common or preferred stock is issued.
- (b) Year of issue, and if during the taxable year, the exact date of issue.
- (c) Consideration (nature and amount) received therefor.
- (d) If the consideration was other than cash, an exposition of the method used in determining the value with due regard to the limitations upon tangible and intangible property paid in for capital stock.

In cases where capital stock is returned to the corporation as a gift or for a consideration substantially less than par, an entry is

**Donated or
treasury
stock.**

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sometimes made charging treasury stock and crediting treasury stock surplus. At other times the acquisition of treasury stock is differently treated on the books. The donation of such stock occurs, quite often, immediately after the original issue of capital stock, the object being to make the capital stock fully paid and non-assessable, and thereafter to permit its sale at a value less than par. Where stock was originally issued for goodwill, patents, or any assets of unknown value and subsequently returned to the corporation as a gift or for a consideration substantially less than par, the taxpayer should be prepared to submit the relevant facts for the examiner's inspection. If the corporation had on hand at any time during the taxable year any treasury stock, in order for the Bureau to verify the proper adjustment of invested capital on account of such treasury stock, copies of journal entries covering the original issuance, repossession and any subsequent adjustments are required. Treasury stock may not be included in invested capital. When such treasury stock is actually sold, the amount received therefor, or the adjusted average if sold during the taxable year, may be included in invested capital.

When treasury stock has been purchased by the corporation at a discount and is in the treasury at the beginning of the taxable year, the cost of such stock should be deducted from the

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sum of the stock shown as outstanding at the beginning of the taxable year plus the surplus and undivided profits as of that date.

When treasury stock has been purchased by a corporation at a premium, being set up on the books at cost, and is in the treasury at the beginning of the taxable year, the par value of such stock should be deducted from the amount shown as issued and the premium should be deducted from the surplus or undivided profits unless it had already been charged to surplus on the books.

Whenever a corporation claims as invested capital certificates of indebtedness, bonds, debentures or securities called by other names, such as preferred stock (so-called), the examiner will desire a blank copy of these certificates in order to determine whether such obligations are deferred with respect to the payment of both interest and principal to the interest of the general creditors.

Certificates of indebtedness, debentures, etc.

Preferred stock declared to be capital stock in the records of the corporation, although convertible into first mortgage bonds, should be treated as invested capital so long as it is not actually converted.

Preferred stock.

2. Surplus

A claim for a paid-in surplus under Item 5, of Schedule A, Form 1103, for 1917, or Schedule E, Form 1120, for 1918 or subsequent years,

Paid-in surplus.

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should be accompanied by details supporting the claim. Item 2, of Schedule B, Form 1103, and Item 5, of Schedule A, Form 1103, cover practically the same ground. The difference lies in the fact that in the first case the paid-in surplus is entered on the books and in the second place the paid-in surplus represents a hidden reserve. While paid-in surplus is sometimes termed "capital surplus," quite often the latter represents nothing more or less than an appreciation of assets. Where this is the case due regard should be given to the adjustments required to be made under Item 6, of Schedule C, Form 1103, or Item 5, of Schedule G, Form 1120.

Paid-in
surplus as
result of
intangible
values.

Where a corporation has acquired a mixed aggregate of tangible and intangible property with an issue of its capital stock, and this mixed aggregate of tangible and intangible property is carried on the books at a value in excess of the par value of the capital stock issued therefor, the paid-in surplus resulting is to a certain extent due to the presence of these intangibles. In such a case, the Bureau requires that a segregation of values be made with respect to the tangible and intangible values thus acquired, and that the paid-in surplus be reduced by the amount of such intangibles if such intangibles do not exceed the paid-in surplus. If such intangibles are in excess of the paid-in surplus, this entire paid-in surplus is, in ac-

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cordance with the rules laid down by the Bureau, required to be eliminated.

By surplus is meant not only the amount that may be called surplus on the books of the taxpayer, but any account that is in the nature of surplus, undivided profits, profit and loss, loss and gain, and other similar items. For a proper computation of invested capital, it is not safe to take the surplus and undivided profits (and other accounts of a similar nature) shown on the balance sheet without a close scrutiny of the real nature of such accounts. In almost all cases it will be found desirable to analyze the surplus accounts with a view to getting into invested capital only the actual paid-in surplus and the real earned surplus, i. e., "earned" from an income tax point of view. Such analysis should if possible cover all the years of the taxpayer prior to the taxable year and may show, in addition to the net income each year, any appreciation of assets resulting from appraisals, any extraordinary mark down of assets, any dividends paid resulting in an impairment of capital, excessive or inadequate depreciation or depletion written off, and any charges to surplus because of the creation of reserves for bad debts, contingencies, etc.

Earned surplus and undivided profits.

In connection with this analysis of surplus, it is sometimes advisable to analyze plant accounts. Cases are known where taxpayers in years of poor business have erroneously capi-

Analysis of plant accounts.

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talized repairs. It is sometimes difficult to determine whether a charge to a plant account really represents an asset value, or is an expense. However, a test of certain selected charges may be made, to determine if the concern, through a number of years, has followed a consistent policy, in items charged to plant and to expense accounts.

When, in some cases, taxpayers have charged additions to expense, and expenses to plant accounts, it will be desirable to prepare an analysis of the plant accounts for each year, showing the following:

- (a) Balance at the beginning of the year.
- (b) Expenses, such as ordinary repairs, charged to the plant account.
- (c) Additions charged to plant account.
- (d) Plant sold or junked and credited to plant account.
- (e) Depreciation credited to plant account.
- (f) Renewals charged to plant account.
- (g) Balance in plant account at end of year.
- (h) Balance in depreciation reserve at beginning of year.
- (i) Depreciation credited to depreciation reserve.
- (j) Renewals charged to depreciation reserve.

Dividends
declared a
part of
invested
capital.

Where dividends were declared during the preceding taxable year, but are not payable until sometime during the taxable year, such "dividends declared" may be treated as invested capital (a part of surplus) at the beginning of

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the taxable year. Taxpayers should not treat dividends payable as surplus when the date of payment has passed, as they are then liabilities and should be classed as such.

Stock dividends, in accordance with a recent decision of the United States Supreme Court, have been held not to be taxable income. Corporations and other taxpayers subject to the tax based on invested capital, who have prior to the taxable year received such stock dividends from either domestic or foreign corporations, and credited surplus with the amount thereof, are required to make an adjustment of surplus to arrive at the correct surplus for invested capital purposes unless both the old stock and stock received as a dividend were sold prior to the taxable year. **Stock dividends.**

Under the application of income and excess profits tax laws, reserves fall into two classes: **Reserves.**

(1) Those created by charges which are allowable deductions from gross income, such as for interest, taxes, commissions, and other accrued or ascertained expenses, depreciation and depletion.

(2) Those created by charges which are not allowable deductions from gross income, such as for bad debts, contingencies, hazard, rebates, sinking funds, bond redemption and Federal income and excess profits taxes.

Reserves of the second class may be included in the invested capital, but under no cir-

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cumstances are the charges to surplus or profit and loss account creating such reserves allowable deductions from gross income for income tax purposes.

3. Adjustments to Capital and Surplus by Way of Additions or Deductions

Indebtedness the interest on which is not deductible from income for the taxable year 1917.

The proportion of permanent indebtedness, that the interest which is not deductible from income in computing income tax for 1917 is of the total interest paid, may be included in invested capital for 1917 in accordance with the provisions of Article 44, Regulations 41.

In order to calculate the interest-bearing indebtedness for the year, and the amount of interest allowable as a deduction, the taxpayer should prepare for his and for the examiner's subsequent use, a columnar statement showing for the interest-bearing indebtedness falling under Item 6(a) of Form 1031 the following:

(a) Amount outstanding at the beginning of the taxable year distributed according to each rate of interest applicable thereto.

(b) Date and amount of each change in the interest bearing indebtedness during the year, increase or decrease, and the resultant balances distributed according to each rate of interest applicable thereto. Where changes are so numerous that such a statement is not practicable, a statement should be prepared showing the balance of such indebtedness at the be-

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ginning of each month distributed according to interest rates.

The taxpayer should bear in mind that any amount added to invested capital in accordance with Article 44, Regulations 41, must be based on the amount of interest for the taxable year not allowable as a deduction because of the statutory restrictions as to the amount of interest deductible, and in no case may the amount to be added to invested capital be based on disallowances which represent interest for prior years.

In accordance with a ruling of the Bureau in the application of the provisions of Article 44, Regulations 41, relative to the excess profits tax, a corporation which has both temporary and permanent indebtedness may assume, to the extent of its permanent indebtedness, that any interest not an allowable deduction has been paid upon its permanent indebtedness.

The term "permanent indebtedness" means indebtedness which in the normal course of the business is continued from year to year as a part of the established financial procedure of a corporation. If the indebtedness is of this character, the term or nature of the particular obligation by which the indebtedness is evidenced at any time is not material. Thus, short-term notes used to acquire borrowed capital the use of which the corporation plans to continue

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after the maturity of the notes by meeting the matured notes with the proceeds of the other borrowings, may be regarded as permanent indebtedness within the meaning of Article 44. Bonds, mortgages or other similar obligations about to fall due may be treated likewise. If in the regular financial procedure of the corporation these obligations will be met by the proceeds of other indebtedness, such obligations may be treated as part of the permanent indebtedness. In its application of the foregoing the Bureau has regarded as permanent all interest-bearing indebtedness the interest on which is subject to the statutory limitation as to the amount deductible.

Cash value of tangibles in excess of par value of stock issued therefor.

Where tangible property has been paid in by a stockholder to a corporation as a gift or at a value definitely known or accurately ascertainable as of the date of such payment, clearly and substantially in excess of the cash or other consideration paid by the corporation therefor, then the amount of the excess is deemed to be paid-in surplus. Generally, allowable claims for paid-in surplus will arise out of transactions in which there has been no substantial change of beneficial interest in the property paid in to the corporation. In all cases the proof of value must be clear and explicit. Claims for paid-in surplus usually arise in the case of partnerships or closely held concerns incorporated for a nominal amount hav-

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ing no relation to the actual value of the property paid in.

Where a claim for adjustment is made under the above rule, the taxpayer should submit a full statement showing the kind of property, the date when paid in, its value on that date, and how such value was determined. Where such value has been determined by appraisals, sufficient data to enable an expert in that particular line of business to pass upon the accuracy of the appraisal should be submitted. For example, where a taxpayer claims an adjustment under this heading on account of mining properties which were paid in for stock, the details of the appraisal should be accompanied by maps of the properties showing developments, size of the veins, estimated ore content and amount of ore excavated as of the date of acquisition. The appraisals should be made by disinterested parties qualified as experts and should show upon what basis and by what method of reasoning the values were reached. They should also show a record of the production of the properties prior to the date upon which appraisals are based.

**Statement
of facts
required.**

Taxpayers have often claimed as additions to invested capital the difference between the purchase price and the value of the property acquired. In transactions at arm's length such additions represent in fact the capitalization

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of bargains, which are not allowable additions.

Sometimes appreciation, as evidenced by appraisals made as of a date after the date of acquisition, is claimed by taxpayers, but such appreciation since the date of acquisition is disallowed unless it has been realized upon prior to the taxable year.

Cash value
established
by
appraisals.

Where an appraisal has been made after the date of acquisition, but is offered as evidence as of the date of acquisition, its weight as evidence with the Bureau depends in a great measure upon the proximity of the date of appraisal to the date of acquisition. An appraisal made immediately prior to or after the date on which the property was acquired carries weight in cases where it is evident that such an appraisal reveals the true value of the property as at the date acquired. Under exceptional conditions retroactive appraisals have been accepted by the Bureau as a basis for establishing a claim for paid-in surplus.

Where a claim for a value adjustment comes within the scope of the regulations, the Bureau will want to know if such claim is properly supported and if the property upon which the claim is based is still owned and in active use, and that proper provision has been made for losses, depreciation, depletion, and obsolescence.

A convenient statement that the taxpayer might prepare in order to summarize the facts

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in connection with a claim for a paid-in surplus is as follows:

- (a) Kind of property.
- (b) Date when paid in.
- (c) By whom paid in.
- (d) If still owned and in active use at the beginning of the taxable year.
- (e) Value at date paid in.
- (f) How that value was determined.
- (g) Amount of depreciation or depletion to the beginning of the taxable year.
- (h) Par value of stock issued therefor or value of tangible property paid therefor.
- (i) Amount claimed as addition to invested capital.

Where goodwill is paid for in stock and is subsequently written off the books of the purchasing corporation as depreciation or otherwise, and restored to invested capital, the amount restored is subject to the limitations upon the amount of goodwill acquired with capital stock.

Many taxpayers in past years have made a practice of writing down their assets to a nominal figure, or during prosperous years have taken excessive depreciation. Others have pursued the policy of writing off to expense additions and betterments to their properties. When such practices have been followed, the books do not reflect the true surplus, and ad-

Excessive depreciation written off in prior years.

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justments by way of additions may be claimed for such amounts as have been charged to surplus which under good accounting practice should have been capitalized. When such a claim is made, the Bureau requires sufficient details to clearly substantiate the claim. Where it is practicable, the following data and information with respect to such adjustments will be of assistance in supporting such claims :

- (a) The kind of property on account of which an addition is claimed and whether such property was in existence at the beginning of the taxable year.
- (b) Its cost and whether acquired for cash, tangible property, or the issue of stock.
- (c) The year in which acquired.
- (d) The probable life after acquirement.
- (e) The depreciation written off each year since acquisition of the property.
- (f) The amount of repairs and renewals on account of such property with a view to ascertaining at what standard of efficiency the property was maintained. In the case of renewals, whether these were charged against the reserve for depreciation, to profit and loss account, or to an asset account.
- (g) In the light of the information obtained from the above, a statement showing the proper amount of depreciation which should have been charged to profit and loss.
- (h) The amount restored to invested capital.

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Schedule B, Form 1103, and Schedule F, Form 1120, contain provisions for miscellaneous adjustments. Taxpayers often claim additions under these schedules that are not warranted by the law or regulations, for instance, a corporation that built its own plant at a cost of \$50,000, estimated a contractor would have charged \$75,000 for building the plant and therefore claimed \$25,000, the theoretical saving, as an addition to invested capital. Such additions are obviously not allowable under the law. However, if the taxpayer could show that the cost as reflected by the books was incorrect due to the fact that overhead had been charged to expense instead of being capitalized as part of the cost of building the plant, such overhead could be claimed as an addition to invested capital provided adequate proof acceptable to the Commissioner was obtainable to satisfactorily substantiate the claim.

Miscellaneous adjustments.

Another type of claim often made is for an addition to invested capital on account of the appreciation of assets based upon their earning power. For example, Corporation X manufactures machine tools, and due to the fact that it has been able to construct machines to do a large part of the work previously performed by hand, its profits are far in excess of those of its competitors in the same industry. The corporation has been earning 65 per cent on its investment whereas its competitors have

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been earning 40 per cent, and it therefore capitalizes its earnings in excess of the average earned by its competitors and claims this appreciation as a part of its invested capital. Claims based upon the above theory are not allowed. In some instances, however, such cases may be considered special cases and a request may be made to have the profits tax assessed upon the basis of the average tax of representative corporations in the same or a similar line of business. This feature is more fully outlined in Chapter V.

Securities are sometimes adjusted on the books to market values. Where such adjustments do not affect taxable net income, as in the case of a dealer in securities, an adjustment of invested capital should be made in an amount equal to the difference between the actual cost of such securities and their book value at the beginning of the taxable year.

Limitation
of intangi-
ble value
acquired
with capital
stock.

Intangible assets, except patents, acquired prior to March 3, 1917, with the issue of capital stock are limited for the taxable year 1917 to (a) cash value at date of acquisition, (b) the par value of the stock issued for the intangible property, or (c) 20 per cent of the outstanding capital stock at March 3, 1917, whichever is lowest.

Under the Revenue Act of 1917, patents and copyrights are treated in a separate group not classified as intangibles, but not embracing all

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the privileges of tangible property. Under the Revenue Act of 1918, patents are classed as intangible.

The limitation for 1918 and subsequent years in the case of intangibles paid in for stock or shares prior to March 3, 1917, is 25 per cent of the par value of the total stock or shares of the corporation outstanding on March 3, 1917. For intangibles acquired on or after March 3, 1917, the limitation is 25 per cent of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year. In no case, however, may the total exceed 25 per cent of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year. The value at which such intangibles may be included in invested capital is further limited to their cash value at date of acquisition, and to the par value of the stock issued therefor.

Intangible property purchased after March 3, 1917, with shares of the capital stock of a corporation may in no instance be included in the invested capital of the purchasing company under the Revenue Act of 1917 at a value in excess of that at which the selling company would have been entitled to include such intangible property in its invested capital under the Revenue Act of 1917, had no change in ownership occurred.

Most contracts are intangible property and in **Contracts.**

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the absence of a ruling to the contrary by the Commissioner of Internal Revenue should be so regarded for the purpose of making returns. Contracts are regarded as tangible property only when they relate to rights in tangible property to such an extent that their value arises chiefly therefrom. Leaseholds and casinghead gas contracts are illustrative of the class of contracts that are regarded as tangible property.

Often a taxpayer attempts to set up or appreciate patents or goodwill in connection with the payment of a stock dividend or of a credit to surplus, but this practice is incorrect and the entire amount of such items thus created will be disallowed.

Taxpayers often include in invested capital a goodwill valuation up to the prescribed per cent of the outstanding capital stock at March 3, 1917, or of the total outstanding capital stock at the beginning of the taxable year, without any proof of cash value. The taxpayer, however, is required to submit data supporting the actual cash value at the date of acquisition of goodwill or patents acquired with the issue of capital stock.

Methods of
valuation of
intangibles.

Some of the methods employed in determining or testing the cash value at acquisition of intangible property, are as follows:

- (a) Earning capacity of the predecessor's business prior to acquisition by the taxpayer.

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- (b) Sale of capital stock of the taxpayer at or about the time of acquisition of the goodwill or patent.
- (c) The earning capacity of the business after the acquisition of such goodwill or patent.
- (d) The fair market value of the capital stock as determined by the assessment of the capital stock tax.
- (e) Cash offers for the sale of the business.
- (f) Known sales of similar property.

The difficulty of satisfactorily determining the cash value of intangible properties has been recognized by the Bureau. For this reason the Bureau has not laid down any rigid rules to be followed in such determination. The above are methods, however, which have been found satisfactory in many cases.

Only that part of the earnings not used for establishing the value of patents may be used in establishing the value of goodwill. In establishing the value of goodwill or patents on the basis of earnings it is customary to ascertain the average net earnings and the average net tangible assets for a representative period. The excess of the earnings over a reasonable return on the net tangible assets (what is reasonable depending of course upon the nature and hazard of the business and the value of money at the time) may be capitalized at a reasonable rate to determine the value of the intangibles. In more or less staple lines of business it has been held

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that a rate of net income of 8 per cent on average net tangibles and 15 per cent on intangibles would be considered reasonable.

It should be borne in mind that each case must be decided on its own merits, as it is impossible to hold to any hard and fast rule as a basis for the determination of the value of intangibles.

Tangible
property
paid in for
stock.

Under the Revenue Act of 1917, there may be included in invested capital tangible property paid in for stock or shares prior to January 1, 1914, at either (a) the actual cash value of such properties on that date, or (b) the par value of the stock or shares specifically issued therefor, whichever is lower.

Acquisition
prior to
January 1,
1914.

When tangible property paid in for stock prior to January 1, 1914, had a cash value at acquisition which was less than par value of the stock specifically issued therefor, but has appreciated in value since the time of its acquisition so that its cash value at January 1, 1914, equals or exceeds the par value of the stock issued therefor, such property should be taken into invested capital under the Revenue Act of 1917 at the par value of the stock issued therefor less depreciation thereon from January 1, 1914, to the beginning of the taxable year. If the cash value at January 1, 1914, is less than the par value of the stock issued, the actual cash value at January 1, 1914, represents the invested capital value of the particular asset

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subject to an adjustment for proper depreciation from January 1, 1914, to the beginning of the taxable year. The taxpayer should be careful not to include in the computation of the cash value as of January 1, 1914, of the assets originally acquired with stock, any assets acquired for a consideration other than with stock as provided for in this paragraph. This provision in the Revenue Act of 1917 does not exist in the Revenue Act of 1918.

Tangible property paid in for stock or shares on or after January 1, 1914, should be taken into invested capital under the Revenue Act of 1917, at the actual cash value of such property at the time of payment irrespective of the par value of the stock or shares issued therefor.

Acquisition
on or after
January 1,
1914.

Where capital stock has been issued for such tangible property as leaseholds, contracts, mining rights, and properties of like nature, the taxpayer should support the valuation of such property as of the date of acquisition or as of January 1, 1914, whichever is material.

The majority of taxpayers have claimed, for 1917 and subsequent years, that the cash value of the tangible assets paid in for stock and entered on the books at the par value of the stock issued therefor was equal to, or greater than, the par value of the stock. In such cases the taxpayer, in order to be prepared to substantiate his contention that no appreciation has been included in the accounts, should assemble

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all the available data showing proof of cash value. Particular scrutiny is given to cases where, as the result of apparent overcapitalization, the excess profits tax is small in comparison with that of other taxpayers in the same industry.

Methods of justifying valuations.

There are usually several ways for a taxpayer to justify his valuations. Assessed valuations for local tax purposes may be useful where real estate is the property in question. Due consideration, however, must be given to the percentage of actual value of the particular class of property customarily assessed in the given locality. Mortgages or bonded indebtedness secured by the property, and well verified cash offers for the property, are of significance. Where property is subject to fire risk, the amount of insurance carried is sometimes an important item of evidence. Recorded sales of similar property in the same vicinity may be offered as evidence. Appraisals prepared by disinterested experts have weight, but the taxpayer should be able to show that the appraisers were expert and disinterested. The proximity of the time such appraisals were made to the date as of which the appraisals were made has an important bearing upon the weight of such appraisals as evidence.

In certain cases the valuation of tangible property (as entered on the books) paid in for stock includes patents, goodwill or other intan-

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gible assets. In such cases it is often impossible to satisfactorily separate the values of the respective classes. Where this situation obtains, a claim for assessment of the excess profits tax on the basis of Section 210 of the Revenue Act of 1917, in accordance with Article 59, Regulations 41, or the profits tax for 1918 and subsequent years under Sections 327 and 328 of the Revenue Act of 1918, Articles 901 to 914, Regulations 45 Revised, may be made.

Where treasury or donated stock exists, the question arises as to the manner in which such stock was handled in the accounts of the company in the past. If the par value of the stock returned was credited to a surplus account, the amount thus credited to surplus does not represent actual earned surplus. Therefore the surplus account should be closely scrutinized (particularly where such stock was sold prior to the taxable year) to determine whether surplus has been properly adjusted in respect to treasury or donated stock. Many taxpayers have erroneously handled this matter, as under certain circumstances, because of the arrangement of the return forms, it has been very easy to fall into the error of making a double deduction in 1917 as well as in 1918 on account of treasury or donated stock.

Stock returned to the corporation as a gift or for a consideration substantially less than its par value.

Where a reorganization has occurred after March 3, 1917, and an interest or control of 50

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Valuation of assets acquired in reorganizations—
Article 50, Regulations 41; and
Articles 931 to 941, Regulations 45 Revised.

per cent or more remains in the same persons, in order to determine any appreciation which may have resulted, it is necessary to prepare balance sheets of the predecessor and the present concern immediately prior to and after the date of reorganization, respectively. The accounts on these balance sheets should be similarly classified so as to enable a ready comparison.

Where interest in excess of 50 per cent remains the same.

With respect to reorganizations effected after March 3, 1917, the statute prescribes a limitation upon the invested capital value in the new company of any assets taken over from a predecessor company when an interest of 50 per cent or more in such assets continues in the same hands. In such a case these assets may not be included in the invested capital of the reorganized company at a value greater than that at which they could have been included in the invested capital of the predecessor company. It is clear that the intent of the statute was to eliminate the possibility of increasing invested capital through the mere changing of the form of organization without materially affecting ownership.

Frequently inflation is introduced on the books of the predecessor or vendor before the transfer. It then becomes necessary to make an analysis of capital and surplus accounts of such predecessor or vendor from the date when the business was started to the date of reorganiza-

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tion in order to arrive at the correct invested capital values of the purchaser or successor business.

Where a reorganization or change in ownership has occurred after March 3, 1917, and the control of more than 50 per cent of the business has changed hands, the restrictive clauses of Article 50, Regulations 41, and Article 941, Regulations 45 Revised, outlined above, do not apply. Where the taxpayer's assets acquired for stock have been written up upon such a reorganization, he should be prepared to present proof to the Bureau that such appreciated value represents the cash value at the time acquired.

Where interest in excess of 50 per cent changes hands.

For example, the value of Corporation A's net tangible assets for invested capital purposes January 1, 1920, is \$100,000, the value of Corporation B's net tangible assets for invested capital purposes January 1, 1920, is \$75,000 and the value of Corporation C's net tangible assets for invested capital purposes January 1, 1920, is \$25,000. The stockholders of the above three corporations, by means of blanket deeds, turned over on January 1, 1920, all their assets to a new corporation called Company X, the stockholders of each of the Corporations A, B and C agreeing to accept stock of Company X in consideration for their assets, in an amount equal to the cash value of the net tangible assets as of January 1, 1920, of each

Illustration of application.

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corporation entering into the merger. As the result of an appraisal, Company X distributed its capital stock on the following basis:

	Cash Value of Net Assets Jan. 1, 1920	Shares of Com- pany X Stock Received	Proportion of Entire Stock of Com- pany X
Corporation A	\$160,000	1,600	53 $\frac{1}{3}$ %
Corporation B	100,000	1,000	33 $\frac{1}{3}$ %
Corporation C	40,000	400	13 $\frac{1}{3}$ %
	<hr/> \$300,000	<hr/> 3,000	<hr/> 100%

As Company X was formed as the result of a reorganization after March 3, 1917, and Corporation A stockholders continue to have an interest in excess of 50 per cent in the assets of Corporation A transferred to the reorganized Company X, the assets received from Corporation A cannot be included in the invested capital of Company X at a greater value than they could have been included in Corporation A's invested capital had there been no reorganization.

The invested capital values of Company X would be computed in the following manner:

Cash value of Corporation A's net assets, January 1, 1920	\$160,000
Less appreciation reflected by the appraisal	60,000
	<hr/>
Invested capital value of Corporation A's net assets, January 1, 1920	100,000
Cash value of Corporation B's net assets, January 1, 1920	100,000
Cash value of Corporation C's net assets, January 1, 1920	40,000
	<hr/>
Total invested capital value of assets of Company X, January 1, 1920	\$240,000

PROFITS TAX RETURNS

It should be noted that inasmuch as neither the former stockholders of Corporation B nor those of Corporation C own 50 per cent or more of the capital stock of Company X, the cash value of the net tangible assets of Corporations B and C at January 1, 1920, are not reduced to the value which would have been allowed Corporations B and C for the purpose of computing invested capital.

If Corporation A's stockholders received of the capital stock of Company X only 49 per cent, Corporation B's stockholders 36 per cent, Corporation C's stockholders 15 per cent, then the limitations effective in the preceding example would not apply, as an interest or control of 50 per cent or more does not remain in the same persons, and therefore the full cash value of the net tangible assets of the entire group as of the date of acquisition by Company X could be included in the invested capital of Company X.

With reference to Item 6, Schedule C, Form 1103, and Item 5, Schedule G, Form 1120, covering appreciation of property acquired with cash or other tangible property, the rule is that such property is allowed to be taken into invested capital at the amount of cash paid therefor or the actual cash value of the tangible property paid therefor at the date of purchase. The object of the adjustment provided for in this item is to eliminate appreciation of a kind not

Appreciation not allowable.

FEDERAL CORPORATE INCOME TAXES

subject to income tax other than that allowed under Article 55, Regulations 41, under the Revenue Act of 1917, in connection with tangible property paid in for stock prior to January 1, 1914, and Articles 836, 837 and 868, Regulations 45 Revised, under the Revenue Act of 1918. Such appreciation may have been entered on the books at the time of acquisition, or may have been so entered at a later date as the result of an appreciation in value which has occurred since acquisition. Both in the latter instance and in the case of property acquired at a "bargain" price, taxpayers have erroneously and frequently assumed the appreciation to be an allowable addition to invested capital under the provisions of Article 63, Regulations 41, and Articles 836 and 837, Regulations 45 Revised.

Where property has been purchased with cash, such property may be taken into invested capital at the purchase price subject, of course, to the adjustments provided for in Item 7, Schedule C, Form 1103, or Item 6, Schedule G, Form 1120, and also the rare instances coming under Article 63, Regulations 41, and Articles 836 and 837, Regulations 45 Revised.

Inadequate
provision
for depre-
ciation, de-
pletion and
obsoles-
cence.

In many instances, inadequate provision has been made for depreciation in years prior to the taxable year, and as a result the surplus is overstated. To avoid these general mistakes, the taxpayer should strictly adhere to the pro-

PROFITS TAX RETURNS

visions of Articles 42 and 64, Regulations 41, and Article 839, Regulations 45 Revised.

Although in the case of obsolescence the taxpayer could not in his income tax returns for years prior to 1918 make provision for such obsolescence as was anticipated, he should reduce the surplus by any loss on account of obsolescence actually sustained prior to the beginning of the taxable year, as outlined in Article 143, Regulations 45. The same procedure applies to the provision for losses; the surplus should be adjusted by losses which have actually occurred prior to the beginning of the taxable year.

Obsolete-
ness.
Losses.

Depreciation should invariably be considered in connection with repairs. It is a self-evident fact that a plant which is kept in first-class condition by reason of prompt and adequate repairs does not depreciate as rapidly as a plant which is made to produce its maximum output regardless of its state of efficiency. As a rule plants must be maintained up to a definite standard of efficiency to retain their value as producing units. In cases where all repairs, temporary and permanent, are charged to expense, the taxpayer must of necessity employ a low rate of depreciation. All these factors must be taken into consideration in determining what adjustment of surplus is to be made because of inadequate or excessive provision for depreciation.

Deprecia-
tion.
Repairs.

FEDERAL CORPORATE INCOME TAXES

Inadmissible assets.

In many instances, in preparing returns for 1917, taxpayers have failed to offset their stocks, bonds (other than obligations of the United States) and other assets, the income from which is not subject to excess profits tax, with the corporation's indebtedness, but have deducted the entire amount of such assets from their invested capital. The directions with respect to Item 8, Schedule C, Form 1103, have been a frequent source of misunderstanding on the part of the taxpayer. Many taxpayers have failed to exclude from the amount of liabilities the portion of indebtedness included in invested capital for 1917 and shown as Item 1, Schedule B, Form 1103. There have also been instances where corporations included their own treasury stock as an inadmissible asset through erroneous interpretation of the regulations.

Illustrations of inadmissible assets are stocks in domestic corporations, municipal and state bonds, and like securities. In determining the excess of inadmissible assets over indebtedness, the taxpayer should eliminate from the inadmissible assets any stocks of affiliated companies owned by the company whose operations it has included in its consolidated excess profits tax return.

If the average total of the inadmissible assets for the full year is equal to or less than the average total of indebtedness for the full year,

PROFITS TAX RETURNS

no reduction in invested capital, under the Revenue Act of 1917, should be made. If the former total is in excess of the latter, invested capital must be reduced by the amount of such excess.

The treatment of inadmissible assets under the Revenue Act of 1918 is different from that provided for in the Revenue Act of 1917. As has been indicated in the foregoing, inadmissible assets under the Revenue Act of 1917 are considered as having been acquired with borrowed money. For this reason, only the excess of the average of inadmissible assets during the taxable year over the average indebtedness during the taxable year is taken as reducing what would otherwise be invested capital.

Inadmissi-
bles in 1917
and 1918
compared.

Under the Revenue Act of 1918, the theory is that inadmissible assets have been acquired ratably with the proceeds of the issue of capital stock, with surplus and with borrowed money. For this reason, an adjustment by way of a deduction is made from what would otherwise be invested capital in an amount equal to that proportion of the invested capital (computed before making this adjustment) which the average inadmissible assets during the year bear to the average total assets during the year.

Ordinarily these averages are obtained by taking the total inadmissible assets (after making adjustments to bring these inadmissible assets to the correct invested capital values) at

FEDERAL CORPORATE INCOME TAXES

the beginning and end of the taxable year and dividing by two, and by taking the total assets, including inadmissible assets (after making adjustments to bring all these assets to the correct invested capital values), at the beginning and end of the year and dividing by two. The Bureau, however, requires that where there has been a substantial change during the taxable year in the amount of inadmissible assets, or in the total amount of admissible and inadmissible assets, the effect of such change be averaged exactly from the date on which it occurred.

Inadmissibles acquired out of current earnings.

In connection with the adjustment which is required to be made because of inadmissible assets under the 1918 Act, it should be noted that it is immaterial whether any asset was acquired out of invested capital, or out of profits earned during the year, or with borrowed money. Under the 1917 Act, however, no adjustment is required to be made on account of inadmissibles acquired with current earnings.

Inadmissibles partly admissibles.

Where the income derived from inadmissible assets consists in part of profit from the disposition thereof or where all or a part of the interest (tax exempt) derived from such assets is in effect included in net income because the interest paid on indebtedness incurred or continued to purchase or carry such assets may not be deducted from gross income, a corresponding part of the capital invested in

PROFITS TAX RETURNS

such assets is deemed to be admissible. It should be noted, however, that this qualification with respect to inadmissible assets applies separately to each issue or class of inadmissible securities held by the corporation.

4. Changes in Invested Capital During Taxable Year

Schedule D, Form 1103, and Schedule H, Form 1120, are intended to bring out the facts relative to any capital taken out of the business or to new capital put into the business during the taxable year. Some taxpayers have in the past reported the purchase of additional plant or equipment as an addition to invested capital; this is obviously only a change from a liquid to a fixed asset and therefore does not represent an addition to invested capital. Although a holding company which renders a consolidated excess profits tax return has sometimes reported an issue of capital stock by a subsidiary to such holding company as an addition to invested capital, it is evident that for the consolidated group no additional capital has resulted unless a part of the additional stock issued has been purchased by minority interests.

Where payments have been made in advance on account of the issue of capital stock, the dates of such payments should be taken as the dates of the increase in invested capital, rather than the dates of the actual stock issue.

Changes by
way of
additions.

Payments
for
capital
stock.

FEDERAL CORPORATE INCOME TAXES

**Changes by
way of
deductions.**

The due date of dividends declared, rather than the date of the declaration or payment of the dividends, is the factor that determines the question of deduction from invested capital, and the amount thereof. If at the time of such due date the earnings of the year in which the dividend was due have been sufficient to meet the amount of dividends due, the entire surplus carried forward from the previous year may be treated as a continuing portion of the invested capital of the corporation, under the Revenue Act of 1917.

Dividends.

If the due date of payment of a dividend is within the first sixty days of the year, for the purpose of the Revenue Act of 1918 the dividend will be deemed to have been paid out of the earnings or income of the preceding taxable years to the extent of the surplus and undivided profits as of the beginning of the taxable year. If the due date is after the expiration of the first sixty days of the year, the dividend will be deemed to have been paid out of the earnings or income of the taxable year to the extent of the net income available for distribution on the due date of payment.

Taxes.

The amount of Federal income taxes due for 1916 should be taken out of invested capital for 1917 for the proportionate part of the taxable period remaining after the date when the tax was due and payable. For example: Company A's 1916 Federal income taxes amounted to

PROFITS TAX RETURNS

\$3,600, and as the return was filed on the calendar year basis, the date the tax was due and payable was June 15, 1917. The amount to be deducted under Schedule D, Form 1103, for the taxable year 1917, is \$3,600 prorated for 6 16-30 months, which is the proportionate part of the year remaining after the tax was due and payable. It is assumed in this case that the 1916 taxes were not accrued and deducted from gross income for 1916.

Under the
1917 Law.

Computations of the above nature under the 1918 Regulations are on the daily rather than the monthly basis and $\frac{200}{365} \times$ the 1917 tax due would represent the amount to be deducted from invested capital for 1918 in the case of a company filing on the basis of the calendar year.

Under the
1918 Law.

For 1919 and subsequent years, each quarterly installment of the tax should be prorated on the basis of the number of days in the period from the due date of the installment to the end of the taxable year. In case a taxpayer is reporting on the calendar year basis the computation may be simplified by deducting, under Schedule H, 42.260274 per cent (42.144809 per cent in leap years) of the amount of Federal income and profits taxes payable for the preceding year.

Article 857 of Regulations 45 specifically outlines the manner or method of determining available net income for distribution. In computing the available net income for distribution,

Method of
determining
available
net income.

FEDERAL CORPORATE INCOME TAXES

the accrued Federal income, excess profits and war profits taxes must first be deducted from the aggregate earnings up to the date the dividend is payable. In cases where the amount of the dividend payable exceeds the difference between the undistributed earnings of the taxable year accrued prior to the due date of the dividend and the accrued Federal income and profits taxes on all earnings accrued prior to that date, the amount of the dividend in excess of net income available for distribution will be prorated and deducted for the remainder of the taxable year from the surplus carried forward from the previous year.

The following illustration shows the manner in which the available net income should be determined in such cases:

Capital stock January 1, 1919	\$400,000.00
Surplus January 1, 1919	100,000.00
<hr/>	
Invested capital January 1, 1919	\$500,000.00
Total earnings for 1919	120,000.00
Dividend paid April 1, 1919	40,000.00
Proportionate part of earnings to April 1, 1919...	30,000.00
Income and profits taxes to April 1, 1919, as computed below	7,403.83

COMPUTATION OF INCOME AND EXCESS PROFITS TAX

Excess profits credit:		
8% of \$500,000 invested capital.....	\$40,000.00	
Specific exemption	3,000.00	
Excess profits credit		\$43,000.00
<hr/>		
Proportion of credit to April 1, 1919,		
$\frac{90}{365}$ of \$43,000.....		\$10,602.74
Invested capital applicable to the period from January 1, 1919, to April 1, 1919,		
$\frac{90}{365}$ of \$500,000.....		123,287.67

PROFITS TAX RETURNS

COMPUTATION OF TAXES

20% of invested capital....	\$24,657.53	
Less excess profits credit...	10,602.74	
	<hr/>	
Amount subject to 20% tax.	\$14,054.79	\$2,810.96
Amount subject to 40% tax.	5,342.47	2,136.98
		<hr/>
Total excess profits tax.....		\$4,947.94
Income to April 1, 1919....	\$30,000.00	
Less excess profits tax	\$4,947.94	
Exemption $90\frac{3}{365}$ of \$2,000	493.15	
	<hr/>	5,441.09
	<hr/>	
Taxable at 10%.....	\$24,558.91	2,455.89
		<hr/>
Total income and excess profits tax.....		\$7,403.83
Amount of dividend payable April 1, 1919	\$40,000.00	
Net amount of Income to April 1, 1919.....	\$30,000.00	
Less taxes accrued to April 1, 1919	7,403.83	
	<hr/>	
Net income available for dividend.....	22,596.17	
	<hr/>	
Dividend considered to have been paid out of surplus January 1, 1919.....	\$17,403.83	
Amount to be deducted from invested capital under Schedule H, Form 1120:		
$27\frac{5}{365}$ of \$17,403.83.....	\$13,112.47	

It should be noted that where the Bureau, because of erroneous treatment of dividends paid, has to make adjustments in Schedule D, Form 1103 for 1917, in the case of a corporation, the income tax returns of the various stockholders will probably have to be amended.

Where a corporation purchases its own stock during the taxable year no deduction therefor is required to be made in determining the

FEDERAL CORPORATE INCOME TAXES

changes in invested capital during the taxable year, provided the corporation can satisfactorily show that such stock was acquired with available earnings of the taxable year.

A stock dividend does not constitute a change in invested capital, since it is merely a transfer from surplus to capital stock account.

In cases where the stockholders of the corporation have been assessed and such assessments paid in during the taxable year, these payments should be considered as additions to invested capital for the period from the dates thus paid in to the close of the taxable year.

5. Deduction from Net Income to Determine Amount Subject to Profits Tax

Under the
Revenue
Act of 1917.

Each corporation having income subject to excess profits tax for the taxable year 1917, may deduct from the amount of its taxable income, a specific exemption of \$3,000, plus an amount equal to not less than 7 per cent and not more than 9 per cent of the amount of its invested capital. In the case of individuals and partnerships, the specific exemption, instead of being \$3,000, is \$6,000.

If the corporation was not in existence during the whole of at least one of the calendar years 1911, 1912 and 1913, designated by the Act of October 3, 1917, as the pre-war period, and has not succeeded to the control of a business which was carried on during any one or

PROFITS TAX RETURNS

more of these years, the deduction is an amount equal to 8 per cent of the amount of the invested capital, in addition to the specific exemption. If the corporation or a predecessor business was in existence during the whole of at least one of the pre-war years the deduction, in addition to the specific exemption of \$3,000, is an amount equal to the same percentage of the invested capital for the taxable year as the average net income during the pre-war period was of the average invested capital during that period, provided that if such percentage was less than 7 per cent the deduction is to be computed at the rate of 7 per cent, and if more than 9 per cent it is to be computed at the rate of 9 per cent.

The date that a business was established is sufficient to determine whether the concern is entitled to an 8 per cent deduction for 1917 or must base its deduction on the pre-war showing. In the case of one company which was incorporated in the latter part of 1912 but did not actually commence business until 1914, the Bureau ruled that the company was not entitled to a deduction of 8 per cent, as it was in existence during at least one full year of the pre-war period.

**Basis for
deductions.**

Where there was a pre-war existence but no pre-war data is given, the deduction allowed is 7 per cent under the excess profits tax law of October 3, 1917. Where pre-war earnings are

FEDERAL CORPORATE INCOME TAXES

shown to be greatly in excess of 9 per cent, accurate pre-war data is relatively unimportant, as the taxpayer is limited to 9 per cent.

Under the
Revenue
Act of 1918.

However, for the year 1918, the pre-war data is of very great importance, since the war profits credit for that year is \$3,000, plus the average net income for the pre-war period, and plus (or minus) 10 per cent of the increase (or decrease) in invested capital for the taxable year, as compared with the average pre-war invested capital.

In a number of cases corporations have shown a tendency to value assets during the pre-war period on a basis other than that used in the taxable year. Where such different bases are used, adjustments should be made on account of the invested capital values of such assets for each pre-war year affected so as to value such assets upon the correct basis both for the pre-war period and for the taxable year.

Changes in
invested
capital,
pre-war
period.

It is important that the taxpayer handle changes in invested capital during the pre-war period in the same manner as changes in the taxable year.

Many taxpayers have treated dividends paid out in the pre-war period as a reduction of invested capital at the beginning of the year, while dividends paid out during the taxable year are prorated as of the date of payment. The result is that the invested capital in the pre-war period is reduced and the percentage

PROFITS TAX RETURNS

of pre-war earnings to invested capital is correspondingly increased. Of course this is material only where the pre-war earnings, whether correctly or incorrectly computed, range from a percentage above 7 per cent to not more than 9 per cent for 1917, or are in excess of 10 per cent of the invested capital in 1918.

The rule expressed in Article 845, Regulations 45, that Federal income taxes are deemed to be paid out of earnings of the year for which levied, applies to any year of the pre-war period as well as to the taxable year. In such cases, the amounts payable in a succeeding year on account of such taxes may be included in the computation of invested capital until due and payable. It should be remembered that during the pre-war period the due date of such taxes was June 30 of the year following that to which the tax applied.

In computing the average net income for the pre-war period, a year in which a loss occurred should be included, but the net loss for such year should be counted merely as zero and no deduction should be made for the loss. For example, if in 1911 there was a net income of \$12,000, and in 1912 a loss of \$12,000, and in 1913 a net income of \$12,000, the average net income of the three years for profits tax purposes would be \$8,000.

Average net
income
pre-war
period.

FEDERAL CORPORATE INCOME TAXES

6. Balance Sheets

Taxpayers should make certain that balance sheets accompanying the tax returns reconcile with those shown by the books. They should be prepared to present for the inspection of the agents of the Bureau copies of the trial balances and other working papers used in making up the return.

It is often more convenient to make certain adjustments in the balance sheets than to show these adjustments in the several schedules of the return. Below is an illustration of the form in which such a balance sheet might be prepared:

JOHN DOE COMPANY				
Balance Sheet, December 31, 1917				
<i>Assets:</i>	Book	Adjustments		Corrected
	Balance	Debit	Credit	Balance
Cash (including cash on hand and in banks) . . .				
Trade accounts and notes receivable (before deducting reserve for losses)				
Other accounts and notes receivable (to be classified)				
Inventories:				
Raw materials				
Work in progress . . .				
Finished products . .				
Supplies				
Investments (to be classified)				
Loans and advances:				
To officers and employees				
To others				
Deferred charges				

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	Original Balance	Adjustments Debit	Credit	Corrected Balance
Fixed assets:				
Land				
Buildings				
Machinery				
Tools and minor equipment				
Delivery equipment.				
Office furniture				
Other (state charac- ter)				
Patents, goodwill, and other intangible assets:				
Paid for in cash....				
Paid for in stock...				
Entered on books by stock dividend ...				
Discount:				
On bonds				
On stock				
TOTAL				
<i>Liabilities and Capital:</i>				
Notes payable:				
To officers and stock- holders				
To others (including bank loans)				
Accounts payable:				
Trade				
Others				
Accrued expenses				
Reserve for losses on notes and accounts re- ceivable				
Reserves for depreciation and depletion				
Reserve for contingencies, etc., the charges cre- ating which are not allowable deductions from income (to be de- tailed)				
Capital stock outstand- ing* (to be classified) ..				
Surplus and undivided profits				
TOTAL				

CHAPTER V

PERTAINING TO SPECIAL PROVISIONS

1. Consolidated Returns of Affiliated Corporations—2. Assessment of Profits Tax by Comparison with Representative Concerns—3. Nominal Capital and Personal Service Corporations—4. Corporations Conducting Partly Personal Service Business

1. Consolidated Returns of Affiliated Corporations

“Cushion” provisions of the income and profit tax law.

OF particular interest in connection with problems of Federal taxation is the development of the equity features or “cushion” provisions of the income and profits tax law appearing in the Revenue Act of 1918. Among the “cushion” or equity provisions referred to will be found the provisions dealing with amortization, obsolescence, net losses, determination of the profits tax on the basis of representative concerns, taxation of personal service corporations and partly personal service corporations, and in the case of affiliated corporations, determination of the income and profits tax on the basis of a consolidated return. Some of these equity provisions also exist in the Revenue Act of 1917. This chapter deals with the following classes of cases: (a) Affiliated corporations, (b) corporations assessable on the basis of representa-

SPECIAL PROVISIONS

tive concerns, (c) nominal capital and personal service corporations, and (d) partly personal service corporations.

The intent of Congress in writing the provisions with respect to consolidated returns of affiliated corporations is revealed in the following extract from Report of Senate Committee on Finance, December 6, 1918, on the Revenue Bill of 1918:

“Provision has been made in section 240 for a consolidated return, in the case of affiliated corporations, for purposes both of income and profits taxes. A year’s trial of the consolidated return under the existing law demonstrated the advisability of conferring upon the Commissioner explicit authority to require such returns.

Intent of Congress with respect to consolidated returns.

“So far as its immediate effect is concerned consolidation increases the tax in some cases and reduces it in other cases, but its general and permanent effect is *to prevent evasion which cannot be successfully blocked in any other way*. Among affiliated corporations it frequently happens that the accepted inter-company accounting assigns too much income or invested capital to Company A and not enough to Company B. This may make the total tax for the corporation too much or too little. If the former, the company hastens to change its accounting method; if the latter, there is every inducement to retain the old accounting procedure which benefits the affiliated interests, even though such procedure was not originally adopted for the purpose of evading taxation. *As a general rule, therefore, improper arrangements which*

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increase the tax will be discontinued, while those which reduce the tax will be retained.

“Moreover, a law which contains no requirement for consolidation puts an almost irresistible premium on a segregation or a separate incorporation of activities which would normally be carried as branches of one concern. Increasing evidence has come to light demonstrating that the possibilities of evading taxation in these and allied ways are becoming familiar to the taxpayers of the country. While the committee is convinced that the consolidated return tends to conserve, not to reduce, the revenue, the committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but *because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient* both to the taxpayer and to the Government.”

Basis for
consolidation.

Section 240(b) of the Revenue Act of 1918 provides that “two or more domestic corporations shall be deemed to be affiliated (a) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (b) if substantially all of the stock of two or more corporations is owned or controlled by the same interests.”

Percentage
of stock
owned or
controlled
necessary
to require
consolidation.

Article 633 of Regulations 45 states that “the words ‘substantially all the stock’ cannot be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case.” It sets forth the

SPECIAL PROVISIONS

rule, however, that "the owning or controlling of 95 per cent or more of the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute" and it further states that "consolidated returns may, however, be required even though the stock ownership is less than 95 per cent."

The requirement is therefore made that "when the stock ownership or control is less than 95 per cent, but in excess of 50 per cent, a full disclosure of affiliations should be made showing all pertinent facts, including the stock owned or controlled in each subsidiary or affiliated corporation and the percentage of such stock owned or controlled to the total stock outstanding." When all the facts are before the Commissioner, the determination will be made as to the propriety of permitting or requiring the filing of a consolidated return.

That this determination in the case where the ownership or control is less than 95 per cent of the total voting stock outstanding is not a simple matter is readily apparent by reference to the "Affiliated Corporations Questionnaire," which is required to be filed. A great number of facts have to be taken into consideration depending upon the particular case. Because of the fact that consolidation sometimes increases the tax and sometimes decreases the

When common ownership of stock is less than 95 per cent.

FEDERAL CORPORATE INCOME TAXES

tax, the decision to consolidate or not to consolidate is of vital importance to the taxpayer as well as to the Government. The Bureau has again and again stated that it is not interested in whether the consolidation increases or decreases the tax, but is interested only in the propriety of requiring a consolidated return as the result of the determination that two or more corporations are "affiliated" within the meaning of the statute. It is therefore advisable to discuss some of the features which have to be considered before the conclusion can be reached that two or more corporations are "affiliated" in cases where the ownership or control is less than 95 per cent of the total voting stock outstanding.

Three classes of affiliations.

There are three well-defined classes of affiliations, which for convenience can be referred to as Class A, Class B and Class C. Affiliations in Class A are those in which the ownership or control of the stock of one or more corporations is in another corporation, commonly known as the "parent" or "holding" corporation. These affiliated corporations, in common parlance, are in the relationship of "parent and child." Class B affiliations are those in which the ownership or control of the stock of two or more corporations is vested in the same interests. By the "same interests" is meant the same individual or individuals, the same partnership or partnerships, or the same corpora-

Class A.

Class B.

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tion or corporations, or any combination of these. These affiliated corporations, in common parlance, are in the relationship of "brother and brother." Class C affiliations are those which combine the features of Class A and Class B affiliations. For the purpose of this discussion it will be sufficient to refer only to Class A and Class B affiliations. Class C.

It is to be noted that the law makes no distinction between the different cases but applies to each the one test of ownership or control of substantially all the stock. The underlying basis of the statutory provision is, of course, not so much the ownership of the stock in itself as it is the control arising from such ownership.

As stated in Article 631 of Regulations 45, "the provision of the Statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation." Consolidation allows the levying of a tax on a group of corporations on the same basis as a single business enterprise.

If a consolidated return were neither required nor permitted for a group of affiliated corporations, the result in tax based on single corporate returns would be in most cases entirely artificial and would be inequitable from the viewpoint of either the Government or the taxpayer. In such a group of affiliated corporations, it would be possible to shift income or in-

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Analogy to
a depart-
ment store.

vested capital, or both, from one corporation to another with a view to reducing the tax, or the mere accidental manner in which the business of the respective affiliated corporations in a group was conducted might result in imposing an artificial and excessive tax. Where substantially all the stock of one corporation is owned by another, even though the business of the subsidiary corporation is different from that of the parent, the two are in the same relation to each other as any single department of a department store is to the entire store, and, therefore, the two corporations are in effect a single business enterprise.

Class A
cases and
Class B
cases com-
pared.

The situation, however, is not always the same where the ownership or control of two or more corporations lies in the same interests, and it would appear that the Bureau of Internal Revenue would ordinarily be justified in requiring a larger percentage of direct ownership or control of the voting stock in such instances before making assessment of the tax on the basis of a consolidated return. In addition, in Class B cases before a consolidated return is permitted or required, the Bureau must be shown that the stock ownership or control of the respective companies is in substantially the same proportion in all of the affiliated corporations. Without this latter requirement, no analogy could be found between Class A and Class B cases. In Class A cases, because of

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the ownership of the stock of the parent or holding corporation, the stockholders of such parent or holding corporation have the same proportionate interest in each of the subsidiary companies as they have in the parent corporation. In Class B cases unless this similarity of interests prevails, it cannot be said that the corporations represent a single business enterprise analogous to a department store, and it could hardly be expected that there would be sufficient shifting of income or invested capital to require consolidated returns.

While reference is made to the power of arbitrarily shifting income or invested capital, the statute does not make this power a basis for determining whether two or more corporations are affiliated for the purpose of requiring a consolidated return. Neither does the statute make the control of the management or operations of two or more corporations the basis. In fact, the ownership of over 50 per cent of the voting stock of one corporation by another would ordinarily be sufficient to give the parent corporation the control of the management and operation of the subsidiary corporation and would permit the parent corporation to arbitrarily shift income or invested capital (perhaps against the wishes of the minority interest in the subsidiary company) from the parent company to a subsidiary or vice versa. Had it been the purpose of Congress to require consolidated

Control of management not deciding factor in determining propriety of consolidation.

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returns in cases where one corporation controls the operation or management of another, it would have been sufficient to have provided that when one corporation owns directly or controls through closely affiliated interests or by nominee or nominees 50 per cent of the voting stock of the other or others, or if 50 per cent of the stock of two or more corporations is owned or controlled by the same interests, a consolidated return would be required.

The test which Congress did provide in Section 240 as a basis for consolidation was the ownership or control of substantially all the stock. The statute itself makes no distinction as to the class or amount of stock. The regulations, having in mind the history and development of consolidated returns, refer to the ownership or control of over 95 per cent of the outstanding *voting* stock as being sufficient for the requirement of a consolidated return. Elsewhere (Article 631) the regulations emphasize the fact that the single business enterprise, even though operated through more than one corporation, is the basis of the requirement of a consolidated return.

Ownership or control of substantially all the stock of a group a requisite for consolidation.

Requirements for 1917 and 1918.

The rulings, as established by the Bureau of Internal Revenue for 1917 and 1918, are practically the same with the exception that in 1917 public service corporations, operated independently and not physically connected or merged, were not required to file consolidated returns.

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A public utility corporation, however, owned by an industrial corporation and operated by the latter as a plant facility was required to be included in the consolidated excess profits tax return of the industrial corporation. Corporations in dissimilar lines of business could also be excluded from consolidations, whereas the practice has been to include partnerships and corporations in a consolidation with the privilege of a \$6,000 exemption. Whenever individuals had their affairs closely interwoven with those of a corporation, substantially all of whose capital stock they owned, it has been the practice to require consolidated returns for 1917. Due to a recent decision of the Committee on Appeals and Review, however, this practice has changed so that at the present time partnerships and individuals are excluded from consolidations for 1917, just as they are excluded in the 1918 Act.

Corporations to be included in a consolidated return for 1917 must be in the same or a closely related business; however, businesses do not have to be of the same kind or class to be closely related. A cotton plantation may be affiliated with a knitting mill and a retail dry goods store, or a coal mine with a steel rolling mill.

For 1917 corporations must be in same or related business.

Inasmuch as the underlying principles of consolidation are the same for all years, a general outline will be given regarding consolidations from an income and profits tax point of view.

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In order to levy the tax according to the true net income and invested capital of a single business enterprise, the Bureau of Internal Revenue has interpreted the Revenue Act of 1917 so as to require the filing of consolidated returns for excess profits tax purposes. For 1918 and subsequent years the law specifically requires the filing of consolidated income and profits tax returns in the case of affiliated corporations.

Status of
foreign cor-
porations.

It should be noted that foreign corporations are neither required nor permitted to file consolidated returns, nor can foreign corporations be included in a consolidated group.

Change in
ownership
during tax-
able year.

When one corporation owns or controls substantially all the stock of another corporation at the beginning of any taxable year, but during the taxable year sells or parts with the control of all or a majority of such stock to outside interests not affiliated with it, or when one corporation during the taxable year acquires the ownership or control of substantially all the capital stock of another corporation not previously affiliated with it, the Commissioner may require separate or consolidated returns to be filed, to the end that the tax may be equitably assessed.

When affil-
iated corpo-
ration is not
included in
consolida-
tion.

Article 635, Regulations 45 Revised, deals with the case of any affiliated corporation organized after August 1, 1914, and not a successor to a then existing business, 50 per cent or more of whose gross income consists of gains,

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profits, commissions or other income derived from a Government contract or contracts made between April 6, 1917 and November 11, 1918, both dates inclusive. This class of corporation may not be included in a consolidated return but is assessed separately on the basis of its own invested capital and net income.

When the voting stock ownership is in excess of 50 per cent, the taxpayer should file an "Affiliated Corporations Questionnaire" so as to enable the Department to determine whether a consolidated return should be made.

When questionnaire should be filed.

Intercompany transactions do not have as much weight as the "effective" stockholdings but have been the deciding factor in a great many so-called border-line cases. Such transactions may arise out of financial or contractual arrangements with affiliated companies, whereby the subsidiaries shift profits to the parent or principal companies, or vice versa, and may be considered by the Department as good cause for requiring consolidation in a certain class of otherwise border-line cases. Of course, such intercompany relations must be of large magnitude to have any particular weight. Transactions of the kind under discussion may involve sales below market, loans at interest below local commercial rates, commissions charged to affiliated companies for securing such loans considerably in excess of what the respective State laws would consider as legal

Artificial shifting of income a factor.

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interest rates, charges for services as agents, or loaning of property, equipment, etc., by one company to another without adequate compensation. Any other transactions or arrangements between affiliated companies which might effect an artificial distribution of profits or assign to any one company a disproportionate share of net income or invested capital might have a bearing upon the determination as to whether or not a consolidated return should be filed.

**Same
interests.**

Although each case is decided on its own merits, the term "same interests" has been construed to include the following:

In case of stock donated by a parent to a child, or a child to a parent, the combined holdings of parent and child have been considered one interest.

In case of stock donated by an employer to an employee or sold to the employee to be paid for by the application of dividends, or stock sold to the employee considerably below its actual market value, the employer and employee have been considered the "same interests" in determining consolidation, unless there was some other factor which would place the employee in the position of a strong minority interest.

**Ownership
as con-
strued by
the Income
Tax Unit.**

Ownership or control of substantially all of the stock of a corporation is the basis for consolidation. Ownership is construed to mean

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beneficial ownership, and in the event the owner of record turns over the benefits to other interests, the parties receiving the benefits would be considered the interests owning the stock.

Control does not refer to the management or operation of a corporation but to the capital stock. The controlling interests, parent company in Class A consolidations or stockholders in common in Class B consolidations, must own or control substantially all of what is known in the Bureau as "effective" stock. The meaning of "effective" stock will be more fully explained later.

Control as construed by the Income Tax Unit.

There are numerous ways of exercising control over stock, some of which are as follows:

(1) Control by means of the holdings of his immediate family, where the principal stockholder's interest with that of his wife, children or dependent parents represents substantially all the stock.

(2) Where the minority interests have given a valid option to the controlling interest to purchase such minority interests' holdings at a price agreed upon, with the right to exercise such option at any time, the holder of the option is considered as having control of the minority stock, especially if the minority interest is an officer or employee of the company.

(3) Stock donated by the controlling stockholder to a relative or employee in many instances has been held to be virtually under the control of the donor.

(4) In the case of employees who are allowed to subscribe for stock in the corporation in which they

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are employed, the dividends of the corporation being applied against the cost of the stock, or when stock is sold to employees with the stipulation that it cannot be resold to anyone other than the corporation, such stock has been deemed to be under the control of the corporation.

**“Effective”
stock.**

Consolidated returns are permitted or required in some instances when over 50 per cent but less than 95 per cent of the “effective” stock is held by the “same interests.” However, cases where consolidations are permitted when less than 75 per cent of the effective ownership is held by the same interests are very few, while those between 75 per cent and 95 per cent are common. The propriety of consolidation in such cases depends entirely upon the relation of the interests involved and the intercompany transactions carried on. Before permission will be granted by the Bureau to consolidate companies in the above groups, a clear presentation of all pertinent facts must be submitted to the Department.

“Effective” stock represents ownership which has an effective voice in the management of a corporation and is directly interested in or capable of controlling in whole or in part any shifting of income between corporations within an affiliated group. The effectiveness of various classes of capital stock depends upon the characteristics of the stock and the limitations

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placed thereon. The decision as to whether certain corporations are affiliated within the meaning of the statute is usually based upon the proportion of holdings of "effective" stock.

Ordinarily common voting stock is entitled to all the earnings over and above the amount required to meet the preferred stock dividends and is the first to feel the effect of any losses; it is therefore considered "effective" stock. The powers delegated to preferred stock differ materially in various corporations so that it may or may not be "effective." Preferred stock which has voting rights and participates in the earnings of the corporation above the regular dividend rates is "effective."

Common stock ordinarily is effective stock.

Preferred stock which has no voting rights if the surplus is sufficient to cover dividend requirements, and does not participate in the earnings above the regular dividend rates, is usually regarded as not "effective." The Bureau has ruled that voting preferred stock is not effective where the fixed dividends have been paid regularly or where a sufficient surplus is available for dividends due on such stock. Voting preferred stock may become "effective" at any time when the dividends are passed and no surplus is available for distribution.

Preferred stock usually not effective stock.

When all or part of the stock is held during the taxable year by a voting trust, conditionally or subject to any option or agreement, oral or

Voting trust.

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written, expressed or implied, the question of its effectiveness depends entirely on the agreement or contract.

Distribu-
tion of
profits on
basis other
than stock-
holdings.

If the profits from the business are not distributed in accordance with the stockholdings or if stockholders distribute the dividends among themselves on a basis entirely different from their holdings, the Department will in such cases ignore the stockholdings and establish the propriety of consolidation on the basis of the equitable beneficial ownership.

Effect of
shifting of
earnings on
consolida-
tion.

Taxpayers in their applications for permission to file consolidated returns have been laying undue stress upon the shifting of earnings from corporation to corporation, whereas in Class A cases it seldom has great weight in the determination of the propriety of consolidation. However, it is usually taken into consideration as evidence to establish the fact that various corporations are, in effect, a single business enterprise.

Potential-
ities rather
than actual-
ities im-
portant.

The potentialities rather than the actualities govern in the determination of consolidation. If the stockholdings in two or more corporations are such that it makes no financial difference to the stockholders to which company income is allocated, a consolidated return would be required whether there was an artificial distribution of profits or not. On the other hand, where there is a minority interest of substantial proportions, it is quite possible for

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a controlling interest to exploit a subsidiary at will, but the Department has not allowed a controlling corporation to profit by its own wrongdoing by including such a subsidiary in the consolidation.

A long-term lease of the entire property of one corporation to another, ranging from about 50 to 999 years, which frequently happens in the case of railroads and public service corporations, has been considered a basis for consolidation.

Long-term lease basis for consolidation.

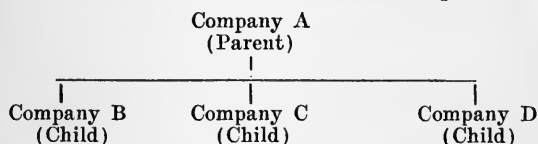
In the case of a trust, where beneficiaries holding certificates evidencing their interest under a so-called "Massachusetts trust" agreement annually elect persons delegated to conduct the affairs of the trust, thus retaining a voice in the business, the trust is an association and will be included in a consolidated return under the same conditions as corporations.

Massachusetts trust may be included in consolidations.

Some of the types of affiliations might be illustrated graphically as follows:

Types of affiliations graphically illustrated.

" Parent and Child " relationship



" Brother and Brother " relationship

	<i>Stockholders</i>	<i>Ownership</i>
Company A (Brother)	{ X Y Z	20% 30% 50%

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Company B (Brother)	{	X	20%
		Y	30%
		Z	50%
Company C (Brother)	{	X	20%
		Y	30%
		Z	50%

Variation of " Parent and Child " relationship

Company A
(Grandparent)

Company B
(Parent)

Company C
(Child)

Combination " Brother and Brother " and " Parent and Child " relationship

<i>Stockholders</i>			<i>Stockholders</i>		
X	Y	Z	X	Y	Z
30%	30%	40%	30%	30%	40%
Company A			Company B		
(Brother of Co. B and			(Brother of Co. A and		
50% owner of Company R)			50% owner of Company R)		

Company R
(Owned jointly by Co. A and Co. B)

Company S.
(Child of Co. R)

Illustrations indicative of great variety existing.

The illustrations given above are indicative of the great variety of affiliations which may exist. In actual practice in the Bureau of Internal Revenue each of these varieties and many more have been found. Some of the relationships are quite intricate and naturally the problems that arise are not easy of solution. The types, however, that are most usually found

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are the simple "brother and brother" relationship and the "parent and child" relationship. The "brother and brother" relationship is as a rule confined to the smaller organization. The larger industrial consolidations are as a rule of the type of "parent and child" relationship. The author will, therefore, largely confine himself to the method of handling these two types in the computation of consolidated net income and consolidated invested capital.

While the accounting involved in the computation of consolidated net income and consolidated invested capital in these two types of affiliations is much the same, yet in certain particular instances the treatment is different. The author will indicate the general procedure to be followed and will point out the principal differences in the handling of the two classes.

The consolidated return, on form 1120, should be filed by the parent or principal reporting company in the office of the Collector of Internal Revenue of the district in which it has its principal office. Each of the other affiliated corporations is required to file in the office of the Collector of its district, form 1122.

The consolidated excess profits tax for 1917 and the consolidated income and profits tax for subsequent years may be allocated among the several affiliated companies on any basis which suits their convenience. It is preferable, however, in order to simplify the process of assess-

Mechanics of computation of consolidated net income and invested capital.

Form 1120 for principal reporting company and Form 1122 for other affiliated companies.

Allocation of tax based on consolidated return.

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ment and collection of taxes, that whatever tax is shown to be due on the basis of the consolidated return, be allocated in the first instance to the parent or principal reporting company. Any adjustment with respect to these taxes which it may be deemed advisable to make may be made on the books of the several affiliated corporations. If as a result of an audit by the Bureau an additional excess profits tax for 1917 or additional income and profits tax for subsequent years results, it is similarly preferable that such additional tax be allocated to and paid by a single company of the group. Or if the audit results in a determination that the tax has been either overassessed or overpaid, it is likewise more convenient to have a claim for abatement, or a claim for refund or credit as the case may be, filed by a single company of the group.

Method of
preparing
consolidated
return.

In support of the consolidated return, where practicable, the various exhibits and schedules necessary to be submitted should be prepared in columnar form, giving from left to right substantially the following data:

- (a) Names of accounts.
- (b) Totals after adjustments and eliminations have been made. (The figures in this column are those which eventually find their way to the return form proper.)
- (c) Adjustments and eliminations before arriv-

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ing at the figures in column *b*. (The items in this column should be coded with numbers or letters so that all contra items may be readily identified. In complicated and involved cases it is often desirable to prepare supporting schedules or statements in explanation or clarification of the adjustments and eliminations made in this column.)

Schedules should be in columnar form.

(*d*) Totals of all like items before adjustments and eliminations are made.

(*e et seq.*) Names of companies, using one column for each company included in the consolidated return, starting with the parent or principal reporting company.

The form suggested above would apply to consolidated balance sheets, income statements, surplus analyses, etc., to which this form, with modifications where necessary, is adaptable.

In the case of consolidated returns involving a large number of companies, it is desirable to arrange the companies in groups of five to ten with a column for the totals of each group, and then recapitulating these totals on a final summary sheet.

It is very important that all exhibits, schedules and working papers be carefully arranged and indexed. These exhibits, etc., should be consecutively numbered or lettered and should have complete headings giving the following information:

Index and cross references necessary.

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- (a) Name of company.
- (b) Nature of schedule, i. e., whether balance sheet, depreciation schedule, etc.
- (c) Period covered.

Where figures are transferred from one schedule to another, such transfers should be indicated by cross references.

Computation of consolidated net income.

In the computation of the consolidated net income, the purpose of a consolidated return should always be borne in mind, i. e., to enable the Bureau to tax as a single business entity a group of corporations affiliated under the law and regulations. In such a single business entity neither profit nor loss can be realized as a result of intercompany or interdepartmental transactions in the group of companies included in the consolidated return. In order for a profit to be taxable or a loss to be deductible from gross income in the case of affiliated companies, such profit or loss must result from transactions other than intercompany or interdepartmental, that is, transactions with interests other than those included in the consolidated return. In the event that intercompany and interdepartmental transactions (such as sales) have occurred, it is necessary to eliminate any profits or losses resulting from such transactions in order to arrive at the true consolidated net income.

Inter-company and inter-departmental profits and losses must be eliminated.

Transactions of the kind contemplated in the preceding paragraph are quite common in any

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group of affiliated industrial corporations. For example, a company manufacturing soil pipe may own all the capital stock of a corporation in the business of mining coal and iron which it sells to its parent company on the basis of the current market price which may be above or below cost to the mining company. The prices paid by the manufacturing company to the mining company are the costs used in the accounts of the manufacturing company. So long as *all* the product purchased by the manufacturing company during the taxable year is consumed in the process of manufacture of the soil pipe during said taxable year, and the soil pipe thus manufactured is sold during such year, there is neither unrealized profit nor unrealized loss, on account of such intercompany transactions, to the affiliated companies treated as a single business enterprise. This is so because any profits or losses to the mining company resulting from sales to the parent company are offset by increased or decreased costs of manufacturing to the manufacturing company. Under such circumstances no elimination of intercompany profits or losses need be made.

**Illustration
of inter-
company
transac-
tions.**

The situation cited in the preceding paragraph, that is, where all the product purchased by one affiliated company from another is in effect sold in the same year by the purchaser, is the exception to the rule. More frequently,

**Inter-
company
profits or
losses in
inventory.**

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of the product purchased by one affiliated company from another, some has not been sold by the purchaser in the same year, and if the product thus purchased and on hand at the close of the taxable year is taken into the inventory on the basis of the cost to the purchasing company, and there has been an intercompany profit or loss, the consolidated net income (that is, the net income of the affiliated companies treated as a single business enterprise) may reflect unrealized profit or loss. For this reason any unrealized profit or loss existing in inventories of affiliated companies and resulting from transactions between such companies must be eliminated in order to arrive at the true consolidated net income.

A simple illustration.

The foregoing may be made clear by a simple illustration. Company A and Company B are affiliated within the meaning of Section 240 of the Revenue Act of 1918, during the calendar (taxable) year 1920. On July 1, 1920, Company A sold Company B certain securities for \$200,000, which securities cost Company A \$150,000. On the books of Company A there was therefore shown a profit of \$50,000 as a result of this transaction. On the books of Company B these securities are carried at the price paid by it, viz., \$200,000. It is clear that for both companies, treated as a single economic unit, no gain has been realized as a result of this transaction. It is therefore necessary

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to eliminate the profit shown on the books of Company A.

In the case of certain large corporations, it has been observed that the plant accounts have been unwittingly inflated. This has arisen, for example, through the transfer by one affiliated corporation to another of material at a price in excess of cost to the first company, and the use of such material in the construction of plant or equipment by the second company for itself. Such material thus finds its way into the plant accounts of the purchasing corporation on the basis of the cost to it of such material. Where this has been the case the taxpayer as a rule has failed to make the proper adjustments in the preparation of the income and profits tax return.

Inflation of capital assets.

In so far as intercompany profits result from the sale of capital assets, they are usually easy to adjust. The difficulties arise in the adjustments of profits when the product of one company is sold to another. It has been previously explained that goods sold by Company A to Company B at a profit and resold by Company B, the profit reported by Company A on these intercompany sales is offset by the increased cost of goods sold by Company B.

Adjustment is necessary, however, for the amount of intercompany profit or loss included in the inventory at the beginning and end of the year. Consolidated net income will exceed the

Elimination must be made at beginning and end of year.

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total of the book net incomes by the amount of intercompany profit in the inventory at the beginning of the year, due to the fact that Company B's cost of goods sold for the year is overstated and this overstatement of costs is not offset by any profit reported by Company A, because the profit on those goods has been reported by that company in the previous year. The aggregate book net income must, therefore, be increased by the amount of this overstatement of the current year's cost.

On the other hand, the total of the book net incomes will exceed the consolidated net income by the amount of intercompany profits in the inventory at the end of the year. Company A, the selling company, has taken up profit on these goods in its accounts and Company B, not having yet disposed of them, has not included these goods in its cost of goods sold. The aggregate book net income should therefore be decreased by the amount of intercompany profit in the inventory at the end of the year.

Similarly it is to be noted that where intercompany sales are made at less than cost and inventories are taken by Company B at prices at which the products were sold to it by Company A, the consolidated net income will exceed the aggregate book net income by the amount of intercompany loss in the inventory at the end of the year, and the aggregate book net income will exceed the consolidated net income

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by the amount of intercompany loss in the inventory at the beginning of the year.

Easy as it is to formulate general principles of elimination of intercompany profits or losses in computing consolidated net income, it is very difficult in practice to arrive at the correct amount of the adjustments. Two questions are hard to answer:

Two questions must be answered before making eliminations.

- (a) How much goods purchased from Company A has Company B on hand at the beginning and end of the taxable year?
- (b) What per cent of profit or loss is included in these goods as inventoried by Company B?

Sometimes the purchasing company, Company B, buys all its product from the affiliated company and in such case it is, of course, apparent that the entire inventory of Company B includes an intercompany profit or loss. In other cases, however, Company B buys from outside parties as well as from affiliated companies, and in such cases the amount on hand at the beginning and end of the year which has been purchased from affiliated companies can usually only be estimated. In many cases, where the goods cannot be identified as from whom purchased, it is safe to assume that the goods purchased from affiliated companies remaining in the inventory at the end of the year bear the same relation to the total inventory at that date as the purchases from affiliated companies dur-

What part of inventory was acquired from affiliated corporations.

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ing the year bear to the total purchases during the year.

What part of value of inventory consists of inter-company profits.

When the amounts of intercompany purchases in the inventory at the beginning and end of the year have been ascertained, the amount of intercompany profit or loss included in the value of these goods may or may not be difficult to determine. Where sales are made by one affiliated company to another at a fixed percentage of profit or loss, the adjustment is comparatively easy; for example, if it is ascertained that Company B has on hand at the end of the year \$110,000 worth of goods purchased from Company A, inventoried upon the basis of cost to Company B, and it is found that Company A makes sales to Company B at a fixed profit of 10 per cent, it is obvious that the intercompany profit on these goods on hand at the end of the year is \$10,000, and the aggregate net income should, therefore, be decreased by that amount. Similar adjustment would, of course, be necessary for inventory on hand at the beginning of the year and, under the same circumstances, the aggregate of the book net incomes for the same year increased accordingly.

Where goods are sold at a certain percentage of profit.

Where goods are sold at market prices.

If intercompany sales are not made on the basis of a fixed percentage of profit but are made on the basis of the regular selling price of the selling company, it is often feasible to apply the percentage of gross profit of the selling

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company for the year to the amount of intercompany goods on hand at the end of the year and thus arrive at the intercompany profit in the inventory at the close of the year. Similar adjustment would be made of the inventory at the beginning of the year, using the average gross profit of the selling company for the previous year.

It is obvious that it is practically impossible to satisfactorily adjust intercompany profits in inventories solely on the basis of any set rules. The facts in each particular case must be carefully studied, and whatever conclusion is reached must be in the light of the circumstances in each particular case.

Each case
based on its
own merits.

In order to arrive at the correct invested capital of a group of affiliated corporations, the entire group must be treated as one unit operated under common control. The first step in this direction is the preparation of a consolidated balance sheet in accordance with standard accounting practice, which will reflect the actual assets, liabilities, capital and paid-in and earned surplus of the affiliated group.

Consolidated
invested
capital.

Such a balance sheet requires that all intercompany items, as intercompany notes and accounts receivable and payable, intercompany profits or losses in inventories, and claims of one company against another, be eliminated. Intercompany notes discounted to outsiders are liabilities of the entire group and should be

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Preparation of consolidated balance sheet.

shown as such. If intercompany accounts do not reconcile they should be satisfactorily explained in the return. Capital asset accounts should not include intercompany profits. Stocks and bonds issued by any of the affiliated companies and owned by companies in the affiliated group are to be eliminated.

Consolidated invested capital in Class A relationship.

In a "parent and child" consolidation, i. e., when a parent or holding company owns the stock of the subsidiary companies, the assets of the subsidiaries cannot be included in the consolidated balance sheet at a value greater than the consideration paid by the parent company for the stock of the subsidiaries, plus the undistributed surplus of the subsidiaries earned since the date of their acquisition by the parent. Therefore, if the net assets of the subsidiaries at date of acquisition of the stock are carried on the books at a value greater than the cost to the parent company such excess must be eliminated from the consolidated balance sheet. On the other hand, if the cash or cash value of the consideration paid by the parent company plus the undistributed surplus of the subsidiaries earned since the date of their acquisition by the parent, is in excess of the value of the net assets on the books of the subsidiaries at the beginning of the taxable year, such excess is considered as representing the value of the subsidiary companies' assets in excess of their book value and such excess values

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should be shown on the consolidated balance sheet.

Such consolidated balance sheet will then show, in the case of a "parent and child" consolidation:

Balance sheet of Class A consolidation.

- (a) The capital stock of the parent or principal company.
- (b) The consolidated surplus belonging to the stockholders of the parent or principal company, after having eliminated surplus at acquisition of any subsidiary company.
- (c) The proportion of capital stock, if any, of subsidiary companies not owned by the parent or principal company, together with the surplus, if any, belonging to such minority interest.

It should be noted that in the case of "parent and child" affiliations, the consolidated surplus consists of the paid-in and earned surplus of the parent company plus the undistributed surpluses of the subsidiary companies earned since the dates of the acquisition of their capital stock by the parent or holding company. Operating deficits of any subsidiary company accrued since the date of acquisition of the capital stock of such company are offsets against the surpluses of other subsidiary companies earned since the date of acquisition and against the earned surplus of the parent company.

Treatment of deficits.

Operating deficits.

An operating deficit of the entire group taken

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as a single economic unit does not reduce the paid-in capital of the entire group treated as a single economic unit.

**Capital
deficits.**

A deficit of the entire group taken as a single business enterprise and arising as a result of capital distributions will, however, be taken as a reduction of paid-in capital of the entire group treated as a single business enterprise.

**Subsidiary
acquired
for cash.**

When all or substantially all of the stock of a subsidiary corporation was acquired for cash, the cash so paid is the basis to be used in determining the invested capital value of the property acquired. (See Article 867, Regulations 45 Revised.)

Article 868 of Regulations 45 Revised provides that where stock of a subsidiary company was acquired with the stock of the parent company, the amount to be included in the consolidated invested capital in respect to the company acquired is to be computed in the same manner as if the net tangible assets and the intangible assets had been acquired instead of the stock. If in accordance with such acquisition a paid-in surplus is claimed, such claim is subject to the provisions of Article 837.

**At a
discount.**

When the stock of one company is purchased by another company for cash at a discount, that is, where at the date of acquisition the balance sheet shows the net worth reflected by the books of the subsidiary to be in excess of the purchase price, the excess is eliminated from

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the asset or assets which are inflated on the balance sheet. Where such inflation cannot be definitely determined, the elimination is made first against intangible and then against the tangible assets in the order of their degree of permanence.

Similarly, when the capital stock of one company is purchased by another company for cash at a premium, that is, where at the date of acquisition the balance sheet shows the net worth reflected by the books to be less than the purchase price, the difference between such net worth and such purchase price is added to the asset or assets which are understated on the balance sheet. Where such understatement cannot be definitely determined, the adjustment of the difference by way of an addition is made to the intangibles. At a premium.

When the stock of one company is purchased with stock at a premium by another company, that is, for a par value in excess of the net worth shown by the books of the subsidiary at date of acquisition, the excess, in the absence of evidence to the contrary, is treated as the cost of intangibles purchased with capital stock. Subsidiary acquired for stock.

When the stock of one company is purchased with stock at a discount by another company, that is, for a par value less than the net worth shown by the books of the subsidiary at the date of acquisition, depending upon whether the Revenue Act of 1917 or the Revenue Act of

FEDERAL CORPORATE INCOME TAXES

1918 applies, the question of a paid-in surplus arises.

Invested
capital
adjust-
ments.

With the consolidated balance sheet established, the schedules relating to invested capital on the return are to be completed as in the case of single corporations.

In connection with the computation of consolidated invested capital, the following points should be borne in mind:

(1) No addition to invested capital for 1917 is allowed on account of intercompany interest paid in excess of the statutory limitation as outlined in Article 44, Regulations 41.

(2) The limitation of intangibles is computed on the basis of each separate company when the companies are owned by the same interests, and on the basis of the consolidated group in cases where the stock of the subsidiary companies is owned by a parent or holding company.

(3) The deduction from invested capital on account of inadmissible assets must be computed on the basis of the consolidated group both in "brother and brother" consolidations and in "parent and child" consolidations.

Adjustment
in 1917 be-
cause of in-
terest paid
in excess of
statutory
limitations.

Where interest is paid in excess of the statutory limitation (not including intercompany interest) the practice is to include in invested capital, indebtedness, the interest upon which has been disallowed computed on the basis of separate companies.

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Interest paid by one company to another in an affiliated group filing a consolidated return is not subject to the statutory limitation as to the amount of interest deductible for the purpose of computing the consolidated net income for excess profits tax purposes under the Revenue Act of 1917.

The consolidated balance sheet of a "brother-brother" consolidation, i. e., two or more corporations whose stock is owned or controlled in like proportions by the same interests, will show:

Balance
sheet of
Class B
consolida-
tion.

- (a) The total of the capital stock accounts of all the companies included in the consolidation, exclusive of intercompany stock holdings, if any.
- (b) The total of all the earned surplus accounts and paid-in surplus accounts of the group minus any deficits that may exist in any of the companies.
- (c) The consolidated assets of the group after having made adjustments or eliminations on account of any intercompany transactions.
- (d) The consolidated liabilities of the group after having made adjustments of any intercompany transactions.

It is to be noted that also in the case of this class of affiliations the operating deficit of one or more companies in the group offsets the

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earned surplus of the other affiliated companies in the group.

The paid-in capital and paid-in surplus of the group may not be impaired for invested capital purposes by any operating deficit of the group which may exist.

A deficit resulting from a capital distribution does, however, reduce paid-in capital or surplus.

Hybrid affiliations.

In the case of "hybrid" affiliations, that is, those which combine the characteristics of "parent and child" relationship and of "brother and brother" relationship, the rules applying to both classes of affiliation must be borne in mind in the construction of consolidated invested capital.

For example, take the case of an affiliation as represented by the diagram below:

Individual Stockholders, in same proportion, own all the
Capital Stock of Company A and Company B

Company A
(brother of Company B)

Company B
(owns all the
capital stock
of Company C)

Company C
(child of Company B)

Thus Company A and Company B are in the relationship of "brother and brother." Company B and Company C are in the relationship of "parent and child." The consolidated bal-

SPECIAL PROVISIONS

ance sheet would reflect the consolidation of Company B and Company C on the "parent and child" relationship basis and the consolidation of Company A and Company B on the "brother and brother" relationship basis.

Consolidated invested capital is computed as at the beginning of the taxable period and adjustment is necessary whenever there is any liquidation of or addition to such capital during the period (exclusive of income or losses during the taxable year).

Changes in consolidated invested capital.

An adjustment by way of an addition to invested capital during the taxable year can only be made on account of a capital contribution, for stock or otherwise, by the stockholders to the consolidated group treated as a single economic unit. Conversely, a similar rule applies to adjustments by way of deductions from invested capital during the taxable year. Thus capital stock issued by a subsidiary company to its parent for cash has no effect on consolidated invested capital. Likewise a dividend paid by a subsidiary company to its parent has no effect on consolidated invested capital. The rule may be laid down that transfers within the consolidated group have no effect on consolidated invested capital.

Inter-company transfers not effective changes.

In Chapter IV, pertaining to the profits tax, the question of dividends and Federal income and profits taxes paid during the taxable year, as affecting the invested capital for the taxable

FEDERAL CORPORATE INCOME TAXES

Dividends
and Fed-
eral income
and profits
taxes
paid during
taxable
year.

year, was discussed. The rules laid down there, with due regard, however, to the underlying theory of consolidated returns, apply here. The point to remember is that the adjustments are made on the basis of the consolidated condition, both for "brother and brother" affiliations and for "parent and child" affiliations.

Thus if Company X and Company Y are affiliated and Company X pays a dividend during the taxable year, the consolidated earnings of the affiliated companies up to the due date of the dividend (less the accrued income and profits tax of the two companies to that date) will be considered available for the payment of this dividend.

Illustration. For example, take a 1917 return in which the facts are as follows:

Net income of Company X, including \$100,000 of dividend received from Company Y.....	\$550,000
Net income of Company Y, including \$10,000 of dividends received on stock of a company not affiliated.....	100,000
	<hr/>
Aggregate net income.....	\$650,000
Less dividends received as above.....	110,000
	<hr/>
Consolidated net income subject to excess profits tax	\$540,000

Let us assume that Company X pays \$400,000 in dividends on July 1, 1917. This dividend is paid to outside parties. Company Y holds none of the capital stock of Company X. The adjustment of invested capital in such case is as follows:

SPECIAL PROVISIONS

Aggregate net incomes.....	\$650,000
Less dividend received by Co. X from Co. Y, not to be included as earnings available for dividend distribution	100,000
Net income available for dividends for taxable year..	<u>\$550,000</u>
Net earnings to July 1, 1917.....	\$275,000
Tentative tax accrued to July 1, 1917, on basis of \$1,000,000 invested capital and 9% deduction.....	112,898
Net earnings available for dividends July 1, 1917....	163,102
Dividend paid to outside parties July 1, 1917.....	<u>400,000</u>
Amount paid out of prior years' surplus.....	\$237,898
Adjustment of invested capital for six months.....	118,949

It should be noted in this case that the dividend received by Company Y on stock of a company outside the consolidation, being a dividend received from outside parties, is included in the earnings available for dividend distribution. On the other hand, the dividend received by Company X from Company Y, being an intercompany transaction, is not included in the earnings available for dividend distribution. The Bureau considers, on the receiving side as well as on the paying side, only transactions with outside parties. No adjustment is made for the dividend paid by Company Y to Company X. It is not considered a dividend paid for the purpose of this adjustment of invested capital except to the extent that the 2 per cent tax applies against the recipient corporation, in computing the accrued Federal taxes in 1917. Since this dividend is not considered as a dividend paid, for invested capital purposes, it

FEDERAL CORPORATE INCOME TAXES

should not be included as a dividend received available for distribution.

Where affiliated companies have different fiscal years.

In the case of all consolidated returns, consolidated invested capital must be computed as of the beginning of the taxable year of the parent or principal reporting company, and consolidated income must be computed on the basis of the taxable year of the parent or principal reporting company. In accordance with this rule, the actual figures, if available, should be used in determining the net income of the subsidiary or affiliated corporation for the taxable year of the parent or principal corporation.

Adjustment to principal company's fiscal year must be made.

If, however, actual figures are not available, the net income of each subsidiary or affiliated corporation is calculated by taking that proportion of its net income shown by its accounts for the period ended within the taxable period of the parent or principal company which the number of months falling within the parent company's taxable period bears to the total number of months covered by such subsidiary's period, and adding to this amount that proportion of the actual net income of the subsidiary for its next accounting period which the number of months remaining in the taxable period of the parent or principal company after the closing date of the subsidiary's period last mentioned above bears to the total number of months in such period.

In the last calculation, if the accounting pe-

SPECIAL PROVISIONS

riod of the subsidiary has not closed at the time of filing the consolidated return, the net income for such period should be estimated and then apportioned as previously outlined. In this event, an amended return is required to be filed upon the completion of the accounting period of the subsidiary, recalculating the income by using the actual earnings for the period instead of the estimated earnings used in the original return.

Adjustment usually by method of proration.

Under any circumstances, a full statement as to the method used should accompany the consolidated return.

In order that the invested capital and net income may be accurately determined it is necessary for the affiliated companies to fix their accounting periods to correspond with that of the parent or principal company.

In 1917, very few companies in filing their original returns made the adjustments in consolidated net income which were necessary because of different fiscal years for various companies within the group. In subsequent years the consolidated returns filed were more uniformly correct in this respect.

As an illustration of the method of proration employed in order to bring the net income of several affiliated companies having different fiscal years to the same basis as that of the parent or principal reporting company, the following is given. Company A is the parent com-

Illustration proration of net income.

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pany and its fiscal year ended November 30, 1917. Company B and Company C are subsidiary companies whose fiscal years ended June 30, 1917, and December 31, 1917, respectively.

Net income of Company A, parent company, for fiscal year ended Nov. 30, 1917.....	\$37,500
Net income of Company B, for fiscal year ended June 30, 1917	24,000
Net income of Company B, for fiscal year ended June 30, 1918	15,000
Net income of Company C for calendar year 1916....	24,000
Net loss of Company C for calendar year 1917.....	30,000

The adjustments which are necessary to bring the fiscal years of the subsidiary companies to the same basis as the taxable year of the parent company are made in the schedules of net income for each of the companies separately, as follows:

Schedule 1—Company A—year ended Nov. 30, 1917:	
Net income as reported.....	\$37,500
Schedule 2—Company B—year ended Nov. 30, 1917:	
Net income as corrected.....	20,250
Explanation—adjusted to the fiscal year of the parent company as follows:	
$\frac{7}{12}$ of net income for fiscal year ended June 30, 1917	\$14,000
$\frac{5}{12}$ of net income for fiscal year ended June 30, 1918	6,250
	<hr/>
Corrected net income for taxable year of parent company, as above.....	\$20,250
	<hr/> <hr/>
Schedule 3—Company C—year ended Nov. 30, 1917:	
Net loss as corrected.....	\$25,500
Explanation—adjusted to fiscal year of parent company as follows:	
$\frac{1}{12}$ of net income for calendar year 1916....	\$ 2,000
$\frac{11}{12}$ of net loss for calendar year 1917.....	27,500
	<hr/>
Corrected net loss for taxable year of parent company as above.....	\$25,500
	<hr/> <hr/>

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In the computation of the taxes due under the Revenue Act of 1917, the adjustments illustrated above would be made for excess profits tax purposes only.

In the case of the computation of consolidated invested capital for a group of affiliated companies having different accounting periods, adjustments similar to those set forth in the foregoing have to be made to the accounts of those companies having accounting periods different from the accounting period of the parent or principal reporting company.

Consolidated invested capital where companies have different accounting periods.

In case two or more corporations were affiliated under the law and regulations for less than a full twelve months' period, the general rule has been to include such corporations in a consolidated return for only that period in which they were actually affiliated. Under these circumstances, methods similar to those set forth in the preceding paragraphs in connection with affiliated corporations having different accounting periods or fiscal years, usually have to be employed in order to arrive at the consolidated net income and consolidated invested capital.

Affiliations for less than twelve months' period.

For example, on July 1, 1917, Company A acquired all the capital stock of Company B with which it had not previous to this date been affiliated. Both of these companies had been reporting on the basis of a calendar year. Under these circumstances, Company A will prob-

Illustration.

FEDERAL CORPORATE INCOME TAXES

ably be required to include in its excess profits tax return for the year 1917 the operations of Company B for the period from July 1 to December 31, 1917 inclusive. In this event Company B will be required to file a separate excess profits tax return for the period from January 1, 1917 to June 30, 1917 inclusive.

Pre-war net
income of
affiliated
corpora-
tions.

Article 802 of Regulations 45 Revised deals with the pre-war net income of affiliated corporations. It reads:

“The consolidated net income of affiliated corporations for the pre-war period shall be the average consolidated net income for the pre-war years of such of the several corporations included in the consolidation for the taxable year as were affiliated during the pre-war period, plus the aggregate of the average net income for each of the corporations not affiliated during the pre-war period which were in existence during all of the pre-war period or during at least one full year within the pre-war period. The net income of a subsidiary corporation organized during the pre-war period by an existing corporation shall also be included.”

Pre-war
invested
capital of
affiliated
corpora-
tions.

Article 869 of Regulations 45 Revised deals with the invested capital for the pre-war period of affiliated corporations. It reads as follows:

“The invested capital of affiliated corporations for the pre-war period shall be computed on the same basis as the invested capital for the taxable year, except that where any one or more of the corporations

SPECIAL PROVISIONS

included in the consolidation for the taxable year were in existence during the pre-war period, but were not then affiliated as herein defined, then the average consolidated invested capital for the pre-war period shall be the average invested capital of the corporations which were affiliated in the pre-war period plus the aggregate of the average invested capital for each of the several corporations which were not affiliated during the pre-war period."

In connection with this subject of pre-war net income and pre-war invested capital, the Bureau of Internal Revenue has ruled "that in determining the pre-war net income and pre-war invested capital of any corporation or any group of affiliated corporations, where such corporation or any corporation in such group of affiliated corporations owned or controlled substantially all the capital stock of another corporation or other corporations during the whole or any part of the pre-war period but has before the taxable year disposed of the capital stock of the latter, the income of the latter for that part of the pre-war period during which substantially all of the capital stock thereof was owned by the former be included with the income of the former for the pre-war period and that the investment of the former in the capital stock of the latter be treated during the pre-war period not as an inadmissible asset but in the same manner as if the latter had been actually a branch or department or had been

Corporations affiliated during pre-war period but not during taxable year.

FEDERAL CORPORATE INCOME TAXES

actually branches or departments of the former and the former had held direct title to the assets and business of the latter.”

Principles
of sound
accounting
basis for
principles
applied to
consoli-
dated
returns.

In conclusion, it may be said that the general rule which has been followed by the Bureau of Internal Revenue in the development of the principles applying to the computation of consolidated net income and consolidated invested capital has been to conform to the principles of sound accounting applied to affiliated corporations as a single economic unit provided such principles are not inconsistent with the income tax statutes.

2. Assessment of Profits Tax by Comparison with Representative Concerns

The Revenue Acts of 1917 and 1918 are necessarily designed in their main essentials to apply to the average taxpayer, whether corporation, partnership or individual. Owing, however, to the great number of abnormal cases in all classes of taxpayers it was necessary to make special provision for the application of the profits tax to such cases.

Section 210 of the Revenue Act of 1917 and Sections 327 and 328 of the Revenue Act of 1918 were designed to meet the requirements of a certain class of abnormal cases. Broadly, the purpose of these sections is to prescribe a method of taxation of corporations where there exists an abnormal condition with respect to

Purpose.

SPECIAL PROVISIONS

net income, invested capital or some other factor affecting the profits tax, the object being to place such a corporation in the same position as to taxation as other representative corporations.

In the 1918 Act two specific exceptions are made to the corporations whose profits tax may be assessed under Sections 327-328, viz., (a) where the tax as otherwise computed is high merely because the corporation earned a high rate of profit on a normal invested capital, and (b) where 50 per cent or more of the gross income, computed in accordance with the provisions of the Act, consists of gains, profits, commissions or other income derived on a cost-plus basis from a government contract or contracts made after April 5, 1917, and before November 12, 1918.

Corporations
excepted.

There is added the provision that the profits tax of foreign corporations shall be computed under these sections of the 1918 Act.

Foreign
corpora-
tions.

Under the 1917 and 1918 Acts, the methods of making the adjustment differ in technique, but the results are the same. Under the 1917 Act, the deduction from net income subject to excess profits tax was determined in the special manner described below and thereafter the rates of tax applying to the several income brackets were computed; under the 1918 Act, the percentage of profits tax to net income is determined as outlined below and this percent-

Technique
of applica-
tion.

FEDERAL CORPORATE INCOME TAXES

age applied to the income subject to the profits tax. It will be observed that the change under the 1918 Act merely simplifies the method of computing the tax without in effect changing the result.

In order that a corporation may be considered as coming under these special sections, there must exist an abnormal condition with respect to net income, invested capital or some other material factor affecting the tax.

Statement
to be filed
with appli-
cation.

As outlined in Article 901 of Regulations 45 Revised, application for assessment under Section 328 of the 1918 Act (Section 210 of the 1917 Act) should be made in statement form outlining the reasons for the application, the facts on which it is based, a description of the trade or business, the invested capital and net income for each year since the beginning of the pre-war period, and showing gains, profits, commissions or other income derived on a cost-plus basis from Government contracts made after April 5, 1917, and before November 12, 1918, stating the percentage of such gross income to the total gross income of the corporation.

Invested
capital.

The question here is as to whether invested capital may be satisfactorily computed. Invested capital cannot be satisfactorily computed in every case even though the taxpayer's books tell a clear story. Abnormality in invested capital may arise through ultra-conservative methods of accounting followed in

SPECIAL PROVISIONS

prior years, or through other causes not affecting the corporate accounts and records. Ordinarily the computation of invested capital from data available to the taxpayer will be found unsatisfactory under the following circumstances:

- (a) Entire absence or incomplete condition of records.
- (b) Improper accounting procedure which it can be shown has resulted in so distorting figures, possibly through improperly charging capital items to expense accounts, etc., as to make it practically impossible to correct the errors.
- (c) Where a mixed aggregate of tangible or intangible assets has been acquired by an issue of stock and bonds and it is impossible satisfactorily to show the values or classification at the date of acquisition of the properties received for stock and bonds, respectively.
- (d) Where it can be shown that there is an actual use of capital of importance in the business which is not reflected in statutory invested capital. This might come about through exceptional credit facilities enjoyed by a taxpayer, or through an intangible asset built up during the long existence of a corporation and which is a material income-producing factor. This is true also in cases where extensive advertising campaigns have developed substantial intangible value at a cost much out of pro-

FEDERAL CORPORATE INCOME TAXES

portion to profits derived during the period the advertising was carried on.

- (e) Where an abnormally large amount of borrowed money is used as compared with the invested capital, as computed without the benefit of these special sections. (Under the 1917 Act this would not apply where the addition to invested capital because of the disallowance of interest as an income deduction affords proper relief.)
- (f) Under the 1917 law, failure to allow for amortization, obsolescence or exceptional depreciation due to the war, or the necessity of providing plant facilities which will not be wanted in the trade or business after the termination of the war. (Under the 1918 Act obsolescence was recognized as an allowable deduction similar to depreciation, and special sections were provided to cover amortization of war facilities.)

The flexibility of these sections is well illustrated by recent rulings applying these sections to cases where invested capital and income of the pre-war period were abnormal.

Income.

It is very difficult to definitely classify causes of abnormal conditions in connection with income. It may be stated, however, that a large class is comprised of those cases where income in the taxable year is to a substantial extent the result of activities of former years; another large group consists of those cases in which the element of personal service enters strongly,

SPECIAL PROVISIONS

such cases being very similar to those taxable as "personal service" corporations, but not coming under that section by reason of the employment of invested capital to some extent, or for some other reason. Abnormally large income due to so-called war profits does not furnish a basis for assessment under these special sections.

If a corporation has been held to come within the provisions of these sections, it then becomes necessary to compute the profits tax in accordance with the special procedure. In brief, this consists of the selecting of tax returns of other corporations similarly situated and the application to the income of the taxpayer of the average rate of profits tax paid by these similarly situated corporations (1918 Act). The corporation is requested in the 1918-1919 return forms to name five representative corporations in its locality engaged in the same line of business. On the 1917 return, the names of three such corporations were requested. The returns of these concerns are considered by the Department in arriving at the tax rate, but the Government auditor invariably obtains other comparative returns, selecting eventually as many as a half-dozen if possible. It is desirable to obtain for this purpose audited returns of corporations in the same line of business (if possible, in the same locality) having about the same gross and net income. If it is not possible to select con-

Computa-
tion of tax.

Representa-
tive con-
cerns.

FEDERAL CORPORATE INCOME TAXES

cerns exactly in the same line of business, those in similar lines are considered. On the basis of the information available to it, the Bureau ascertains what concerns are most nearly representative. In each case, the auditor has considerable latitude for the use of judgment in selecting the returns to be used in determining the average profits tax rate to be applied. The basic principle underlying this procedure is to place a taxpayer on the same footing with regard to his tax status as concerns with which he may compete.

Percentage
of tax
to net
income.

The important point, of course, is the tax burden placed upon the corporation, that is, the percentage of tax to net income subject to such tax. As heretofore noted, the provisions of the 1917 and 1918 regulations with respect to these special cases aim at the same result in slightly different ways; the 1918 regulations providing that the comparative method shall be used to determine the percentage of profits tax to be paid, while the 1917 regulations direct the use of the comparative returns to determine the amount which shall be deducted from net income subject to profits tax before applying the rates specified. Theoretically, under the 1917 Act, it was necessary to construct the invested capital. As a practical matter, however, this was accomplished by first determining, following the method outlined above for 1918, the excess profits tax to be assessed, fixing the spe-

SPECIAL PROVISIONS

cific deduction for the pre-war period at 7 per cent to 9 per cent of invested capital and working backwards to set up a figure for invested capital.

It will be appreciated that the application of this section of the law is, to a greater extent than perhaps any of the other sections, a matter of judgment in the particular case and it is therefore necessary that such cases be passed upon by a greater number of auditors than the ordinary case. In fact, it is almost invariably necessary to determine the more important points in conference in the Bureau, and due to this it is not infrequently necessary for the Bureau to request a conference with the taxpayer so that all the relevant facts may be brought out before the amount of tax assessable is determined.

Petition for
special
assessment.

It is doubtless of great assistance to the Department and facilitates the handling of a case to have the facts and information bearing on a given case clearly set forth in such a way that they will be readily intelligible. Also because of the greater necessity for the use of discretion in the determination of these special cases, it is particularly desirable that all the facts be presented. For instance, to take a hypothetical case assumed to have been acted upon by the Department and to which action the taxpayer has some objection, a model statement might contain:

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- (a) Name of corporation, etc.
- (b) Synopsis of the previous steps in the case.
- (c) Description of the type of organization, date established, location of offices, plants, etc., and date of close of year.
- (d) Description of taxpayer's business, bringing out all important distinguishing features, stating any corporate affiliations by way of stock ownership, financial arrangements, etc.
- (e) A statement of the reasons supporting the objections made to the Department's action, based, if possible, upon the figures and facts stated in the original tax return or in any subsequent adjustments by the Department, taking up in detail, for instance, first, the facts relative to income, and, second, similar information with regard to invested capital.

Payment of tax.

Special provisions were made under the 1918 Act for the payment of the tax in these special cases, as follows:

- (a) In case of a domestic corporation unable absolutely to determine invested capital, the installments are to be based on a profits tax of 50 per cent of the net income.
- (b) In case of a domestic corporation able to compute a minimum invested capital, the profits tax is to be based on such invested capital but not to be in excess of 50 per cent of net income.
- (c) For a foreign corporation, the installments are to be based upon a computation of the

SPECIAL PROVISIONS

tax using 1917 invested capital, adjusted for any subsequent changes attributable to business within the United States, such tax to be not more than 50 per cent of net income subject to profits tax.

After reporting the tax due on one of the above bases, the tax is computed by the Bureau, and if the correct installments are shown to be greater than those already paid the additional amount is due and payable within ten days after notice and demand by the Collector of Internal Revenue.

As the maximum tax for 1919 and 1920 would in any event be less than 50 per cent of the net income, the foregoing provisions with respect to the limitations upon the payment of the tax in the first instance, do not in practice apply to those years.

It is, of course, the policy of the Bureau to assess the profits tax on the basis of the statutory invested capital, if this can be satisfactorily done, having recourse to the special sections only in cases which cannot be equitably handled otherwise. While these special sections are commonly called "relief" sections, it does not necessarily follow that the tax, as assessed under these sections, will be lower than under the other sections of the law. The purpose of these sections, it is to be remembered, is to protect a taxpayer against a tax burden heavier than that of others in his situation, due

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to conditions in connection with his accounts and records and other factors bearing on the tax which operate against him when the sections of the law designed to suit the average case are applied.

Where the profits tax is assessed under Section 210 of the Revenue Act of 1917 or under Sections 327 and 328 of the Revenue Act of 1918 for one year, it does not necessarily follow that assessment will be similarly made in another year, nor that even if assessment in another year is similarly made, that similar relief will follow. Each case is treated on its individual merits, and the results depend entirely upon the circumstances of the particular case.

3. Nominal Capital and Personal Service Corporations

What is a
personal
service cor-
poration?

Special provision has been made in the Revenue Acts of both 1917 and 1918 for "personal service corporations" whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor. A corporation in order to be classified as a personal service corporation must derive its income from a profession or business which consists principally of rendering personal services.

SPECIAL PROVISIONS

Section 209 of the Revenue Act of 1917 made no reference to personal service corporations or businesses and applied not only to corporations but also to individuals and partnerships. While the 1917 Act refers only to "a trade or business having no invested capital or not more than a nominal capital," in the interpretation of Section 209 for 1917 with respect to trades or businesses, the Bureau of Internal Revenue has applied the rules as laid down by it for personal service corporations under the Revenue Act of 1918.

1917 and
1918 pro-
visions
compared.

As in the case of determining the propriety of filing a consolidated return in border-line cases and in determining the applicability of the provisions of the statutes with respect to assessment on the basis of representative concerns, each case must be treated on its own individual merits before determination can be made as to whether it comes within the scope of "nominal capital" cases under the Revenue Act of 1917 or "personal service corporations" under the Revenue Act of 1918.

Each case
treated on
its own
merits.

Of the many claims for assessment under the various "cushion" or relief provisions of the 1917 and 1918 statutes, the Bureau of Internal Revenue has probably denied more claims for assessment as a "nominal capital" case or a "personal service corporation" than any other class of claims. Some of the reasons for this are as follows:

Many
claims not
warranted.

FEDERAL CORPORATE INCOME TAXES

Case of
income
dispropor-
tionate to
invested
capital.

(1) Certain concerns have made claims for assessment as "nominal capital" cases simply because their income for the taxable year was greatly disproportionate to their statutory invested capital, and under the circumstances, it was considered that the capital of such concerns was only nominal when compared with the income. Where in such cases the use of capital, whether owned or borrowed, is necessary and is ordinarily an important income-producing factor (particularly when the large return in the taxable year was due to unusual war conditions), the Bureau has uniformly taken the position that neither the "nominal capital" nor the "personal service corporation" provision of the 1917 and 1918 Acts, respectively, apply. For example, a certain merchant had stocked up at the beginning of the year 1917 a large quantity of merchandise which he had acquired at the low pre-war prices. As a result of war conditions he was able to dispose of his goods at many times the cost, with the result that his net income for 1917 was several times the investment which he had in the business at the beginning of 1917. He argued that the capital employed by him in the business was only "nominal" when compared with the income realized therefrom and that therefore he should be assessed only at the 8 per cent rate provided for in Section 209 of the Revenue Act of 1917. The excess profits tax in

SPECIAL PROVISIONS

this case was assessed on the basis of the concern having invested capital. "Nominal capital" has been held by the Bureau to mean capital in name only.

(2) A great many corporations have claimed that they were entitled to assessment in 1917 under Section 209 as having "not more than a nominal capital" because the par value of the capital stock issued was extremely small, in fact only "nominal" as they termed it, although it was admitted that a large amount of borrowed capital was employed in the business. In such cases, if the use of capital is an important income-producing factor, the Bureau will not make an assessment as a "nominal capital" corporation or as a "personal service corporation." For example, a certain realty-holding corporation had issued and outstanding only \$1,000 par value of capital stock and \$500,000 par value of mortgage bonds. It contended that its capitalization was only nominal and that it therefore was entitled to assessment as a "nominal capital" corporation. It was held, however, that this corporation had more than a nominal capital, although such capital was in the form of borrowed money, and that therefore the provisions of Section 209 of the Act of 1917 did not apply.

Case of
nominal
capitaliza-
tion.

(3) There is a large class of corporations whose income is derived from the services of others, and who have filed returns as "personal

Traffic in
services of
others.

FEDERAL CORPORATE INCOME TAXES

service corporations," but whom the Bureau has refused to recognize as such. In this class of corporations, while the stockholders supervised or directed the activities of the employees, the compensation received for the services of such employees could not be primarily attributed to the experience or skill of the stockholders. For example, a certain corporation, employing a large number of people, maintained boot-black stands in various localities of a certain city. All of the stock of this corporation was owned by three men. All their time was devoted to supervising the employees of the corporation and managing its affairs. This corporation filed its returns for 1918 and 1919 as a "personal service corporation," contending that its business consisted in the rendition of personal services. The representative of the corporation argued that when the corporation's employees polished the shoes of customers, they were performing a personal service for such customers, and that therefore the corporation was entitled to be classed as a personal service corporation and be treated for tax purposes accordingly. It was held that this was a case where the income was derived primarily through the labor or services of others, and that even though the stockholders gave their personal attention to the management of the affairs of the corporation so that it was enabled to earn more than other concerns engaged

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in a like or similar business, since it could not be said that its income was due *primarily* to the activities of its principal stockholders, it could not be classed as a "personal service corporation."

(4) There is another class of corporations which although actually engaged in the business of merchandising filed its excess profits tax returns for 1917 as "not having more than nominal capital" and its returns for 1918 and 1919 as "personal service corporations." This class is typified by the small retail store which has been incorporated and the sole stockholder of which is manager, buyer and salesman—"captain and crew" combined. In a particular case the argument was presented that as the business of the corporation consisted of selling shoes to women, the sole stockholder, acting as salesman, performed the service of fitting shoes to his customers; and as he made it his business to try to please them and cater to their personal likes, his motto being "personal service," his business was profitable and under the circumstances it was claimed that the income of the corporation was attributable primarily to the activities of its stockholder. The decision in this case was that the use of capital was the primary income-producing factor and that moreover as the income of the corporation was derived as a result of trading, it could not be assessed for 1917 as a corporation having "no

Type of
small trading
corporation.

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invested capital or not more than a nominal capital" nor for 1918 and 1919 as a "personal service corporation."

So-called
commission
merchants.

(5) Certain other corporations claiming to be commission merchants have filed returns as personal service corporations, but upon the audit of these returns by the Bureau it was determined that the commission business transacted was one in name only, and that the income received while termed "commissions" was in reality profit on the sale of goods. The Bureau in these cases has denied the privilege of classification as "personal service corporations." For example, a corporation was in the business of buying and selling steel. It had three stockholders, all of whom were officers and active in the conduct of the business. These men were technically trained and had wide experience in their line of business. The corporation had only five employees—one bookkeeper, two clerks and two stenographers. The function of the officers was to ascertain the requirements of their customers with respect to certain grades of steel and then to find the people from whom they could obtain this steel at the best price. An offer would then be made to the customers for the particular grade of steel at a uniform price of 10 per cent in excess of what it could be purchased for from the producer. This 10 per cent was regarded as a commission for performing the services of "buyers." The

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so-called commission merchants would then purchase the steel, which they had already sold, from the producer. The argument was made that title was taken to the goods as a matter of convenience only, that the goods never actually passed through the hands of the corporation in question as they were shipped by the producer direct to the customer and that the company carried no stock of goods on hand at any time. Because the corporation assumed all financial responsibility and risk, it was held that although it was apparent in the particular case that the income of the corporation was due primarily to the knowledge, connections, experience and activities of its stockholders, the corporation could not be classed as a personal service corporation, as over 50 per cent of the gross income of the corporation consisted of gains, profits or income derived from trading as a principal. The fact that the earnings of the corporation were termed commissions or fees did not overcome the fact that such earnings represented the difference between the sales prices and costs of the steel sold less the expenses incurred. The Bureau of Internal Revenue has been extremely rigid in adhering to its rule that if the business of the corporation took the *form* of trading, regardless of any other elements present, it could not qualify as a personal service corporation.

(6) Typical of another class of cases for

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Concerns
having no
invested
capital.

1917 is a concern having no invested capital by reason of the limitations of the statute. Concerns in this class contended that as Section 209 of the Revenue Act of 1917 provided for the assessment of businesses having "no invested capital," even though the particular businesses rendered no personal services and the income was derived primarily from the use of capital, and as the particular corporation had no invested capital by reason of the restrictive clauses of Section 207, Section 209 applied. For example, a certain corporation which had reorganized after March 3, 1917, after having gone through the hands of a receiver—the reorganization being for the sole benefit of the creditors—issued \$5,000 par value of capital stock for goodwill and noninterest-bearing notes for the net tangible assets acquired. As goodwill acquired with capital stock after March 3, 1917 cannot be taken into invested capital under the Act of 1917 at an amount in excess of what the predecessor business would have been permitted to take, and as in the particular case the predecessor business would not have been entitled under the statute to any goodwill as invested capital, and as the noninterest-bearing notes represented borrowed money, the corporation was left with no invested capital. The Bureau, however, interpreted the clause in Section 209 "trade or business having no invested capital" as meaning trade or business having no capital, owned

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or borrowed, invested in the trade or business, and as the very foundation for the income of this corporation was the use of substantial capital (i. e., capital in its economic sense, which in this case happened to be borrowed) it ruled that Section 209 did not apply. This case, however, was clearly one in which the Secretary of the Treasury was unable to *satisfactorily* determine the invested capital, and so assessment of the excess profits tax for 1917 was made under the terms of Section 210 by comparison with representative concerns. Assessment in this manner relieved the taxpayer from the undue hardships which would have followed if the excess profits tax had been determined in accordance with the provisions of Sections 201 and 207 of the 1917 Act.

(7) A certain class of publishers furnishes **Publishers.** another illustration of concerns which have applied for assessment of the excess profits tax for 1917 as concerns having no invested capital, that is, at the flat 8 per cent rate, and the tax for 1918 and 1919 as personal service corporations, but where the Bureau has not permitted assessment on such bases. For example, a certain corporation published a daily newspaper of large circulation. The corporation owned its own printing establishment in which it had invested large sums and employed quite a large personnel—reporters, clerks, etc. The editor of the newspaper was the sole stock-

FEDERAL CORPORATE INCOME TAXES

holder of the corporation. The policies of the paper were determined by its editor, who had built up for the paper a substantial reputation. The argument was made that the prosperity of the corporation was due to the indefatigable and untiring energy of the editor, to his far-sighted policies and to his reputation, and that the corporation in giving news of the right kind to the public was educating the public and rendering it personal service. It was ruled, however, that, with all due respect to the editor, substantially all the profits of the corporation could not be attributed to its sole stockholder, and that as capital was a very material income-producing factor assessment could not be made for 1917 as a corporation having "no invested capital" nor for 1918 and 1919 as a "personal service corporation."

Semi-personal service corporation.

(8) Another class of corporations which have made claims for assessment as concerns having "no invested capital" or as "personal service corporations," but which claims have been denied by the Bureau, are those known as "semi-personal service corporations." The businesses of corporations in this class combined the elements of personal service and non-personal service corporations. In these cases the stockholders were actively engaged in the conduct of the business and to their activities a very substantial part of the income was directly due. For example, a certain cor-

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poration which had four stockholders, all of whom were active in the affairs of the corporation, stated that it was in the wholesale produce business as commission merchants. Upon an analysis of the facts, however, it was ascertained that only about one-half of the corporation's net income was derived on a straight commission basis as the result of the sale of products consigned to it. With respect to the products thus consigned no financial risks whatever were assumed by the corporation. The other half of the net income was due to the purchase of produce and the subsequent sale thereof. The corporation with respect to this end of its activities was engaged in trading and assumed such risks as those of market fluctuations, bad debts, failure to accept shipments, etc. The buying and selling was entirely carried on by the stockholders of the corporation and in fact the profits realized on this end of the activities of the corporation were not substantially greater than if these transactions had been conducted on a straight commission basis. The argument was made that substantially all of the income of the corporation was derived from the personal activities of its stockholders and that it should not be discriminated against because of the form that some of the transactions took. These arguments, however, did not satisfy and it was ruled that because of the form in which a considerable part of the business was conducted,

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capital was a necessary and material income-producing factor and that as over 50 per cent of the gross income of the corporation consisted of profits derived from trading as a principal, the corporation could not qualify as a personal service one. Relief was found, however, for 1917 by assessment of the excess profits tax on the basis of that paid by representative concerns and for 1918 by assessment as a partly personal service corporation. This latter class of corporations will be more fully dealt with later.

Corporation whose income is from mere ownership of property.

(9) Claims for assessment as corporations having "no invested capital" or not more than a nominal capital have been made by corporations whose sole income was derived from royalties received under license agreements for the use of patents in the possession of the corporation. For example, in a certain case an individual patented certain devices which were of great use to a certain corporation in the manufacture of its product. Corporation A was organized and this patent was turned over to it for its capital stock. A license agreement was thereupon entered into between the manufacturing corporation and Corporation A authorizing the former to use the patents for certain specified royalties which were to be paid periodically to Corporation A. The claim was made by the representative of Corporation A that the corporation had "no capital," as patents were not

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capital in the sense contemplated by the statute, and that the income derived by the corporation represented the fruits of activities of its stockholders prior to the invention of the particular device and the patenting thereof. The Bureau, however, held that the investment of the corporation in patents established the corporation as one having more than nominal capital within the meaning of Section 209 of the Revenue Act of October 3, 1917, and that where the income of a corporation is derived entirely as a result of the ownership of certain property (such as patents in this case) it cannot be said that the income is derived from the personal activities of its stockholders and that therefore Section 209 does not apply.

In this connection, a recent decision in the United States District Court, District of New Jersey, (268 Fed. 377), is of interest. District Judge Bodine, in dismissing the Government's motion to strike out plaintiff's complaint in an action to recover an additional war excess profits tax for the year 1917 imposed under Section 210 of the Revenue Act of 1917 (the original tax having been paid by plaintiff in accordance with the provisions of Section 209 of that Act on the theory that it was a corporation "having no invested capital or not more than a nominal capital"), said, in part: "Patents were never capital in an economic sense. Congress included them within the term 'in-

Income
from
ownership
of patents.

FEDERAL CORPORATE INCOME TAXES

vested capital' to the extent only of the investment in them; if no investment in them, then they remain in the same class as that intangible something which makes for the wealth of the professional man, the broker, or others engaged in a personal service, which could never be 'capital,' except in name only. The decision of this case, however, need not depend solely upon the meaning of the word 'capital,' to be found in the distinction between 'invested capital' and 'nominal capital,' as used in the Act. The patents which the plaintiff owned were the concrete embodiment of the skill which the plaintiff possessed in its field of activity. This skill or service it bartered for a consideration. Such skill or service is like the service a lawyer in large practice renders for an annual retainer and is very nearly akin to the service which a commission house renders to those who buy and sell through it, or the service of a concern engaged in selling or leasing real estate and in writing insurance. The plaintiff's source of income was that which certain persons were willing to pay it for the use of its skill and knowledge. It is true that skill and knowledge had been reduced to concrete form; but the payment was for the use of the skill and knowledge, and not for any part or parcel of the form to which the skill and knowledge had been reduced. Hence it would seem that in a very real sense the plaintiff was engaged in rendering a personal service, and

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was not employing 'capital,' and certainly no more than a 'nominal capital'."

(10) Theaters represent another class of enterprises which have frequently made claims for assessment as businesses having "not more than a nominal capital" or as "personal service corporations," but which in most instances were denied the privilege of assessment in this manner upon an audit by the Bureau of the returns which were filed. These enterprises contended that they were in the business of entertaining their patrons and that their activities certainly constituted the rendition of personal services, notwithstanding the fact that equipment, a theater building and a considerable personnel were necessary. For example, in one instance, a corporation which had only one stockholder, who was its principal officer and very active in its affairs, owned its own theater building and booked its own shows. The stockholder was a well-known theatrical man. His policy was to give the public the kind of entertainment he thought it wanted and he personally arranged for the procurement of the talent. Arguments were strenuously made that the corporation was certainly rendering personal services as the result of its activities, and as the owner was active in the affairs of the business that therefore assessment should be made as a "personal service corporation." The Bureau, however, ruled that while in a sense the services

Theaters.

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performed by the corporation were personal services, the income of the corporation could not be ascribed primarily to the personal activities of its sole stockholder, and that the possession of its own theater building by the corporation carried with it the presumption that capital was a material income-producing factor. The Bureau in fact held that only the employees of the corporation and those who actually furnished the entertainment were contributing personal services, and it was largely as a result of these services, together with the possession of the facilities owned by the corporation, that the income of the corporation was produced. It was therefore ruled that this corporation could not be classed as a personal service corporation under the Act of 1918. Assessment was made under the invested capital provisions of the statute.

The foregoing decisions have been in each instance illustrations of cases where the particular concern filed its return on the basis of "having no invested capital or not more than a nominal capital," or as a "personal service corporation," but where, upon audit, determination was made that these special provisions of the respective statutes did not apply.

The following illustrations are cases where assessment of the excess profits tax for 1917 was permitted to be made under the provisions of Section 209 dealing with concerns "having

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no invested capital or not more than a nominal capital," and the tax for 1918 and subsequent years under the provisions of Section 218(e) of the Revenue Act of 1918 dealing with personal service corporations:

(1) A corporation was organized by a firm of noted architects. These architects carried on their business thereafter through the corporation. All the stock of the corporation was held by these men in the same proportion in which they were previously entitled to share in the predecessor partnership's profits. The corporation employed a substantial capital in its business. Its capital consisted of office furniture and a considerable fund of cash which was necessary to meet the requirements of a payroll for quite a large staff of draftsmen, clerks, etc. The corporation had filed its excess profits tax return for 1917 under Section 209 of the Act. The question was at first raised as to the propriety of the application of this section to this case inasmuch as the corporation actually employed substantial capital in its business and appeared to derive income as the result of the services rendered by its employees as well as of the services rendered by its stockholders. Upon further analysis and study of the case and after conference with the representatives of the corporation, it was ruled that the income of the corporation was due primarily to the activities of its stockholders inasmuch as the fees col-

Corporation of architects.

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lected, which were very large, were almost entirely the result of the ideas conceived in the brains of these stockholders, and that the capital employed was not more than an incident in the carrying out of these ideas, and that the services of whatever kind rendered by the employees of the corporation received their value from the services rendered by the stockholders. It was therefore held entirely proper to assess this corporation for 1917 as one not having invested capital, and for 1918 as a "personal service corporation."

Commercial
school.

(2) In another case, a corporation conducted a commercial school. It had five stockholders each of whom devoted his time to the affairs of the corporation. These men were expert in their particular lines of endeavor. They prepared courses, inspected the lessons, and supervised the teaching by a dozen others who were much inferior to the stockholders in ability. In this particular case, the corporation required funds to a certain degree for office furniture, stationery, text-books, and the salaries of its employees. The ruling in this case was that the corporation should be classed as a personal service corporation for the reason that its income was derived from a profession or business consisting entirely of rendering personal service and the earnings of which were due primarily to the activities of the stockholders, and in which the employment of capital was only in-

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cidental. The capital employed was of the same nature as that which might be employed by a firm of attorneys having substantial sums invested in a law library, etc.

(3) As an illustration of a corporation in this class, the case of one organized by three photographers to engage in the business of photography is given. These photographers devoted all their time to the business and were experts in their line. They had three assistants. Over 95 per cent of the income came directly from services rendered as photographers. Approximately 5 per cent was the result of income arising from the sale of picture frames. It was decided that as the non-personal element in the business was negligible and incidental and as a very small part of its earnings could be ascribed to such sources, and as substantially all the earnings of the corporation were attributable directly to the personal activities of its stockholders, the corporation was entitled to be classified as a personal service corporation.

**Personal
service cor-
poration
having
a non-
personal
element.**

Another illustration of a corporation coming in this class is that of a corporation engaged in conducting a "beauty parlor." Its stockholders consisted of three women each of whom was active in the affairs of the corporation and devoted all her time to carrying on the work required, such as hair dressing, shampooing, manicuring, etc. The corporation, however,

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carried a line of toilet articles for the convenience of its patrons. Of the income earned by the corporation, approximately 97 per cent was derived directly from fees received as the result of the personal services rendered by its stockholders. Only approximately 3 per cent was derived as the result of profit on the sale of its toilet articles. It was held that, as the non-personal service element was negligible and merely incidental and that as practically the entire income of the corporation was ascribable to the personal services of its stockholders, the corporation was correct in filing its return under the provisions of the 1918 Act dealing with personal service corporations.

Theatrical
company.

(4) A certain leading actress organized a corporation for the conduct of her enterprise. She had associated with her about fifteen people. The capital of the corporation was invested in costumes and scenery, and used for salaries and wages of employees. The actress owned all the stock of the corporation. She played the leading rôles in the acts produced. In this case it was held that the income derived by the corporation was due primarily to the activities of its stockholder, that the corporation was rendering personal services, that capital was not a material income-producing factor, that the cast was only to lend color to the brilliancy of this actress, and that the income derived was almost entirely the result of her

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skill, ability and reputation. Therefore this corporation was treated as a personal service corporation under the 1918 Act.

(5) Another illustration which may be given as coming within the scope of a "personal service corporation" is a small country newspaper, all of the capital stock of which is owned by a few people who are all active in the affairs of the corporation, and where the corporation does not own its own printing plant but has its printing done outside, and where the copy is prepared and edited by the stockholders. In such a case it has been ruled that capital is not an income-producing factor and that the income of the corporation is to be ascribed primarily to the personal services rendered by its stockholders.

Country
newspaper.

(6) Another class of cases considered as having no invested capital for 1917 and as personal service corporations for 1918 and subsequent years is well illustrated by a corporation engaged solely in the business of acting on a commission basis as agent for principals in the sale of goods belonging to the principals where the stockholders of the corporation were actively engaged in the affairs of the business, and the income of the corporation was ascribable primarily to such activities. As an illustration of the above, a corporation in New York was organized by four men, two of whom were salesmen and two of whom were mechanical engi-

Selling on
commis-
sion.

FEDERAL CORPORATE INCOME TAXES

neers. They employed a few clerks and carried just enough capital to meet their expenses. The business of this corporation was to go into industrial plants and make recommendations for requirements as to machinery, etc. This corporation would then order such machinery for its clients as was required, and would obtain from both the vendor and the vendee a commission for services performed. It was decided that all the elements of a personal service corporation were present and therefore assessment of the tax was made accordingly.

Difficulty
of laying
down rules.

It is a very difficult matter to lay down specific rules as to the applicability of the section of the 1917 Act dealing with businesses having no invested capital or not more than a nominal capital, and of the provision of the 1918 Act dealing with personal service corporations. As has been previously mentioned, it is necessary that each case be treated on its own merits, and until all the facts have been carefully considered no decision can be made. The reader is referred to Regulations 45 in connection with the tax of 1918. It will be observed that these regulations appear to be rather rigid and exclusive.

Criticism has been made that while some concerns that are border-line cases may find relief under the section of the 1918 Act dealing with partly personal service corporations and under the provisions of the 1918 Act dealing with tax-

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ation on the basis of representative concerns, there are a great many such cases which do not find sufficient relief under these provisions. It has therefore been urged by many that revision of the law be made with respect to the application of the provision dealing with personal service corporations permitting a larger number and a greater variety of corporations to qualify as personal service corporations.

The status of a corporation under the Revenue Act of 1917 having no invested capital or not more than a nominal capital is fully set forth in Section 209 of such Act and in Regulations 41 covering such Act. The status of corporations qualifying as personal service corporations, the status of the stockholders of such corporations, the method of handling such cases where the corporations report on the fiscal year rather than the calendar year basis, and the method of handling claims for refund of taxes in cases where they have been overpaid, are fully set forth in Regulations 45 Revised covering the application of the 1918 Act. The writer has attempted to confine himself to those aspects of personal service corporations which in his opinion are not sufficiently covered in the regulations.

The author wishes to state that in the cases which he has cited herein, he has taken particular pains to make changes from the actual facts as they existed so that it would be impos-

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sible to recognize the actual case which was under consideration. He has tried, however, to keep such of the essential facts, with possibly slight changes, as to clearly present the applicability of the respective sections of the statutes.

As a summary of the principles applying in the case of concerns coming within the scope of Section 209 of the 1917 Act and Section 200 of the 1918 Act, the following is given:

Illustrations of personal service corporations.

Corporations deriving their income principally from such services as conducting an auction, agency, brokerage or commission business on the basis of fees or commissions are rendering personal service. But if any corporation conducting a business similar to those cited above guarantees the accounts of purchasers, accepts title to the merchandise, or assumes such risks as market fluctuations, bad debts, or damage in transit, it is not considered a personal service corporation, but is taxed as a merchandising or trading concern.

Earnings primarily attributable to activities of owners.

Even though a corporation renders personal service it cannot be classified as a personal service corporation for income tax purposes unless the principal owners or stockholders are regularly engaged in the active conduct of its affairs and to such an extent that the earnings are primarily attributable to their activities. The principal owners and stockholders must also render the principal part of the services. If

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they merely supervise or direct a force of employees the corporation is not a personal service corporation.

In determining whether a corporation meets the requirements of the statute with respect to capital, the test established gives no weight to the fact that the actual investment of the stockholders or principal owners is small or that as a result of the working out of the limitations in the Revenue Acts, such as inadmissible assets and goodwill limitations, little or no invested capital remains.

The deciding factor is the nature of the profession or business as indicated by the services it renders and the extent to which capital is required to carry on such profession or business. If the corporation carries on a business of a kind which ordinarily requires the use of capital, it is not a personal service corporation, regardless of the amount invested by the owners or stockholders. The term capital as used in the statute means not only capital actually invested by the owners or stockholders but capital secured in various other ways. Thus, if capital is borrowed, as evidenced by notes, bonds, debentures, accounts payable or other forms of credit, or if any of the stockholders finance the corporation whether by advancing money on interest-bearing or noninterest-bearing notes or by extending credit to the corporation, all such transactions are consid-

**Use of
capital a
factor.**

FEDERAL CORPORATE INCOME TAXES

ered as evidence tending to prove that capital is necessary and is a "material income-producing factor" and that the corporation is not a personal service corporation.

Specifically
excluded as
personal
service cor-
porations

Under the Revenue Act of 1918 the following classes of corporations are specifically excluded from classification as personal service corporations:

- (a) Foreign corporations.
- (b) Corporations 50 per cent or more of whose gross income consists of gains, profits or income derived from trading as a principal.
- (c) Corporations 50 per cent or more of whose gross income consists of gains, profits, commissions, or other income derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, inclusive.

Relation to
stock divi-
dend deci-
sion.

The question has been raised as to whether the section of the Revenue Act of 1918 with reference to the levying of an income tax on stockholders on their proportion of the undistributed income of personal service corporations is constitutional, in view of the recent decision of the Supreme Court in the case of *Eisner vs. Macomber* (252 U. S. 189) with reference to stock dividends. Under this decision income was defined—"as the gain derived from capital, from labor or from both combined"—"Here we have the essen-

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tial matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property severed from the capital however invested or employed, and coming in, being derived, that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;—that is income derived from property. Nothing else answers the description”—“A stockholder has no individual share in accumulated profits, nor in any particular part of the assets of the corporation, prior to dividends declared.” Based upon sections of the decision such as those cited above, many taxpayers are contending that undistributed income is not taxable. The Bureau, however, has not placed the same construction upon the above decision and continues to assess against stockholders of personal service corporations taxes on undistributed income.

4. Corporations Conducting Partly Personal Service Business

Some corporations derive part of their net income from a trade or business in which the employment of capital is necessary and part of their income from a separate trade or business which if constituting the sole trade or business would bring such corporation within

When in
this class.

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the class of personal service corporations. If the net income derived from the personal service part of the business was not less than 30 per cent of the total net income of the corporation, then the profits tax for the taxable year 1918 and subsequent years upon the total net income would be computed as outlined in Section 303 of the Revenue Act of 1918.

It may be remarked that an astonishingly small number of corporations have filed their returns on the basis of corporations conducting partly personal service businesses. This may be due to ignorance of the existence of this provision in the 1918 statute on the part of corporations that might qualify under this section or may be due to the fact that corporations properly belonging in this class have filed returns on the basis of personal service corporations, expecting that if upon subsequent audit by the Bureau they are unable to qualify as personal service corporations, they can then make application for assessment under Section 303 of the Revenue Act of 1918 as corporations conducting partly personal service business.

Illustration. In the foregoing, in connection with personal service corporations, illustrations have been given of corporations coming under the classification of those conducting partly personal service business. It occurs to the writer that there are numerous corporations through-

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out the country which come under this class. The illustration given in Regulations 45 is that of an engineering concern also engaged in contracting work which amounts practically to trading in materials and labor. It thus received fees from professional services rendered in connection with the engineering and also received income as the result of trading in materials and labor. If the net income derived from the personal service part of the business is not less than 30 per cent of the total net income, then the corporation may qualify as one conducting a partly personal service business. There is a large class of corporations which combine the elements of personal service business and non-personal service business but where it is difficult to satisfactorily determine the net income derived from each source. Thus a corporation may be engaged in the optical business. The principal stockholder of the corporation may be an oculist actively engaged in the conduct of the affairs of the corporation. He may have two or three assistants. It may be the business of the corporation to prescribe glasses for clients or customers and to make up and sell these glasses. No separate fee is collected for the professional services performed; this fee is included in the price of the glasses. In other words, the entire transaction takes the form of trading. The corporation could therefore not qualify as a personal service corpora-

FEDERAL CORPORATE INCOME TAXES

tion. It would appear, however, that if a *satisfactory segregation* could be made of the corporation's net income into that derived from the personal services of the stockholders and that derived from trading, the corporation might qualify under the provisions of Section 303 of the Revenue Act of 1918.

Computation of tax.

In order to compute the tax in this class of cases it is first necessary to apportion or allocate the invested capital and net income of the taxable year and of the pre-war period as between the non-personal service part and the personal service part of the business. If the corporation did not conduct the non-personal service part of the business in the pre-war period, the war profits credit is computed in the manner prescribed by Section 311(b) of the Revenue Act of 1918, i. e., it will be an amount equal to \$3,000 plus 10 per cent of the invested capital for the taxable year.

The profits tax on the non-personal service part of the business is computed at the particular tax rates in effect for the year in question based on the net income and invested capital, both for the taxable year and the pre-war period (if the latter is a factor) applicable to the non-personal service part of the business. Adjustments of the net income and invested capital of the non-personal service part of the business in the pre-war period are required to be made so that such net income and

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invested capital is computed in the same manner as for the taxable year. In many cases, it is impossible to accurately determine what proportion of general expenses apply to the non-personal service and what proportion to the personal service. In these cases an apportionment is made on some equitable basis. The specific profits tax exemption of \$3,000 is prorated to the non-personal service part of the business on the basis of the proportion which the net income from the non-personal service part of the business for the taxable year bears to the total net income for the taxable year.

Having determined the tax upon the non-personal service portion, the tax upon the personal service income will be the same percentage of the latter as the tax on the non-personal service portion of the income is of the non-personal service income, the total tax being the sum of the two taxes. However, the tax on the personal service net income is in no case to be less than 20 per cent thereof unless the tax, if computed in the ordinary way upon the entire net income, would be less than 20 per cent thereof, in which event the profits tax would be computed in the same manner as that of entirely non-personal service corporations subject to the profits tax.

A corporation which is taxable under Section 303 is not a personal service corporation and its stockholders are taxed upon dividends

Status of
stock-
holders.

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received in the same manner as stockholders in an ordinary corporation.

**Section 302
applicable.**

The maximum limitation, as prescribed in Section 302 of the Revenue Act of 1918, upon the profits tax applies to partly personal service corporations in the same manner as to other cases.

CHAPTER VI

PROBLEMS

It will be noted that a large number of the following problems and illustrations are stated to be on 1917 cases. In the main, however, these are applicable to 1918 and subsequent years as well. The exceptions, where the 1917 rule differs from that for 1918 and subsequent years, are outlined in the problems and explained. The problems are intended to illustrate features of the Statutes which taxpayers, as a rule, have found some difficulty in understanding. Particular attention has been given to questions involving consolidated returns.

The important differences in the provisions of the Revenue Acts of 1917 and 1918 are fully covered in the text. The principal differences are, in brief, as follows:

- (1) Dividends received by corporations on domestic corporate stock were subject to a 2 per cent tax in 1917; they are not taxed under the 1918 law.
- (2) Provisions for Obsolescence and Amortization as deductions from income are new in the 1918 law.
- (3) Loss in Inventory, Section 214(a) 12 (1918 law) is a new provision, also the Net Loss provision in Section 204 (1918 law).

- (4) Partnerships are not subject to tax as such under the 1918 Act; they were subject to excess

FEDERAL CORPORATE INCOME TAXES

profits tax in 1917 where net taxable income exceeded \$6,000.

(5) Taxation of profit from sale of mines, oil or gas wells where value has been demonstrated by discovery limited under Section 337 (1918 Act).

(6) Interest paid is practically unlimited as a deduction under the 1918 Act; it was limited for 1917 and previous years.

(7) The provision for consolidated returns in Section 240 is new in the 1918 Act. Consolidated returns were required under the 1917 regulations for excess profits tax purposes only.

(8) Payment of the tax in installments was first introduced in the 1918 Act.

(9) The limitation upon 1917 assessments is 3 years and 1918 assessments 5 years from due date of return. This limitation is upon assessment made in the regular way, by notice and demand, but does not bar a suit by the Government to collect tax due.

(10) Several changes in penalties were made in the 1918 Act, including 5 per cent negligence penalty, which was introduced for the first time in 1918. The claim for credit on account of overpaid taxes is also new in the 1918 law and applies retroactively. The limitation upon claims by taxpayers is made five years from due date of return (Section 252, 1918 Act).

**Profit
taxes.**

(11) The excess profits tax of 1917 applied to corporations, partnerships and individuals; the war profits and excess profit taxes under the 1918 Act apply only to corporations.

(12) "Personal Service" corporations taxed in 1917 are not taxed as such under the 1918 Act. Distributive shares of stockholders in the corporate in-

PROBLEMS

come are taxed to such stockholders as individuals in the same manner as partnerships.

(13) Section 302 (1918 Act) provides maximum limitations upon the profits taxes.

(14) Gold mining corporations are made exempt from profits taxes under the 1918 Act on that part of their income derived from mining gold.

(15) Status of Patents, Trademarks, etc., under the 1917 Act, where they were in a class separate from Goodwill and other intangibles, was changed to include them in the latter class under the 1918 Act. **Invested capital.**

(16) Method of computation of deduction for inadmissible assets changed.

(17) Valuation of tangible property paid in for stock as of January 1, 1914 (Section 207—1917 Act), eliminated in 1918 Act.

(18) The 20 per cent limitation upon intangibles under the 1917 Act increased to 25 per cent under the 1918 Act.

(19) Foreign corporations assessed under Sections 327-328 of the 1918 Act; under the 1917 Act their income from sources within the United States was taxed upon their invested capital computed under Section 207.

FEDERAL CORPORATE INCOME TAXES

PROBLEM 1

Illustration of Method of Computing War Profits Credit When Pre-war Income and Invested Capital Are Used

FACTS:

	<i>Invested Capital</i>		
	1911	1912	1913
Capital stock	\$200,000	\$200,000	\$200,000
Surplus	68,000	62,000	74,000
	<u>\$268,000</u>	<u>\$262,000</u>	<u>\$274,000</u>
Less deduction for goodwill	52,500	52,500	52,500
	<u>\$215,500</u>	<u>\$209,500</u>	<u>\$221,500</u>
Deduction for inadmissibles as shown below.....	64,650	83,800	81,955
	<u>\$150,850</u>	<u>\$125,700</u>	<u>\$139,545</u>

	<i>Inadmissibles</i>		
	1911	1912	1913
Total average assets	\$393,000	\$320,000	\$349,000
Average inadmissibles	<u>118,000</u>	<u>128,000</u>	<u>130,000</u>
Percentage to be deducted from invested capital....	30%	40%	37%
The invested capital for 1918 is.....			\$260,000.00
Average invested capital for pre-war period.....			138,698.33
Average net income for pre-war period.....			27,333.33

PROBLEM:

From the facts given above, compute the War Profits Credit under the Revenue Act of 1918:

SOLUTION:

Invested capital for 1918.....	\$260,000.00
Average invested capital for pre-war period	<u>138,698.33</u>
Increase	\$121,301.67

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10% of increase	\$12,130.17
Plus average pre-war earnings.....	27,333.33
Specific exemption	3,000.00
	<hr/>
War profits credit	\$42,463.50
	<hr/> <hr/>

PROBLEM 2

Illustrating Method of Computing Income and Excess Profits Tax in 1917 for a Period Less Than Twelve Months

PROBLEM:

Computation of Income and Excess Profits Tax for the Six-months Period July 1, 1917, to December 31, 1917:

FACTS AND SOLUTION COMBINED:

Capital stock July 1, 1917.....	\$100,000
Paid-in surplus July 1, 1917.....	100,000
	<hr/>
Invested capital July 1, 1917.....	\$200,000
Addition under Schedule D, capital paid in September 1, 1917, \$60,000 prorated for four months— $\frac{4}{6}$	40,000
	<hr/>
Average invested capital for taxable period.....	\$240,000
\$240,000 reduced to six-months basis— $\frac{6}{12}$ thereof, or	120,000
	<hr/> <hr/>
Net income July 1, 1917, to December 31, 1917....	\$ 75,000
Invested capital	120,000
Deduction—8% of \$120,000 plus \$1,500 ($\frac{6}{12}$ of \$3,000 specific exemption).....	11,100

COMPUTATION OF EXCESS PROFITS TAX:

Per cent of Invested Capital		Income	Deduction	Taxable	Rate	Tax
Not over	15%...	\$18,000	\$11,100	\$ 6,900	20%	\$1,380
"	" 20%...	6,000		6,000	25%	1,500
"	" 25%...	6,000		6,000	35%	2,100
"	" 33%...	9,600		9,600	45%	4,320
Over	33%...	35,400		35,400	60%	21,240
		<hr/>				<hr/>
		\$75,000				\$30,540
		<hr/> <hr/>				<hr/> <hr/>

FEDERAL CORPORATE INCOME TAXES

COMPUTATION OF INCOME TAX:

Net taxable income for period.....	\$75,000	
Excess profits tax	30,540	
		<hr/>
Balance taxable at 2%.....	\$44,460	\$ 889.20
Taxable at 4%.....	44,460	1,778.40
Excess profits tax.....		30,540.00
		<hr/>
Total tax		<u>\$33,207.60</u>

PROBLEM 3

Illustrating Method of Computing Income and Excess Profits Tax for a Period of Less than Twelve Months Included in the Calendar Years 1916 and 1917

PROBLEM:

Computation of Income and Excess Profits Tax for the Eight-Months Period beginning November 1, 1916, and ending June 30, 1917:

FACTS AND SOLUTION COMBINED:

	<i>Invested Capital</i>	
Capital stock November 1, 1916.....	\$230,000	
Capital stock issued March 1, 1917, \$200,000 effective four months—4/8	100,000	
		<hr/>
Average invested capital for eight-months period....	\$330,000	
Reduced to eight-months basis— $\frac{8}{12}$ of \$330,000, or...	\$220,000	
Pre-war deduction—8% of invested capital, or \$17,600, plus \$2,000 ($\frac{2}{3}$ of specific exemption of \$3,000)	\$19,600	

COMPUTATION OF EXCESS PROFITS TAX:

Per cent of Capital	Income	Deduction	Taxable	Rate	Tax
Not over 15%...	\$33,000	\$19,600	\$13,400	20%	\$2,680
" " 20%...	11,000		11,000	25%	2,750
" " 25%...	6,000		6,000	35%	2,100
	<hr/>				<hr/>
	\$50,000				\$7,530
	<hr/>				<hr/>

PROBLEMS

Excess profits tax apportioned to the period in 1917
 ($\frac{6}{8}$ of \$7,530) \$5,647.50

COMPUTATION OF INCOME TAX:

Net taxable income for period.....	\$50,000.00	
Less excess profits tax.....	5,647.50	
		Tax
Balance subject to 2%.....	\$44,352.50	\$ 887.05
Amount subject to 4% ($\frac{6}{8}$ of \$44,352.50)	33,264.37	1,330.57
Excess profits tax		5,647.50
		\$7,865.12
Total tax		

It will be noted in this case that the excess profits tax is prorated for the reason that only six months of the eight months in the taxable period falls within the calendar year 1917. No excess profits tax is assessable for the two months falling within the calendar year 1916. The fraction used is $\frac{6}{8}$, being the ratio of the number of months in 1917 to the number of months in the entire taxable period.

PROBLEM 4

Application of Tax Paid on Income from Tax-Free Covenant Bonds

FACTS:

Corporation A receives interest of \$2,000 on the bonds of Corporation B which contain a 2 per cent tax-free covenant clause.

Corporation B pays \$40 income tax for Corporation A, in accordance with this covenant.

QUESTION:

How shall the income from these bonds be returned by Corporation A?

FEDERAL CORPORATE INCOME TAXES

ANSWER:

Corporation A shall report as income \$2,040. It can credit the total tax assessable with \$40.

Article 31, Regulations 45 Revised, states in part:

"The amount of income tax paid for a bondholder by an obligor pursuant to a tax-free covenant in its bonds is in the nature of additional interest paid the bondholder and must be included in his gross income."

See Article 376, Regulations 45 Revised, for that part relating to the credit against the total tax assessable.

PROBLEM 5

Illustration of Inadmissible Assets

FACTS:

Securities held entire year:

United States Steel Common	\$200,000
United States Steel Bonds	100,000
United States Government Bonds	150,000
New York City Bonds	150,000
	<hr/>
	\$600,000
	<hr/>

<i>Indebtedness constant during year.....</i>	<u>\$300,000</u>
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PROBLEM:

From the above data compute the deduction under Schedule C on Form 1103.

SOLUTION:

The following securities are in the "inadmissible asset" class:

United States Steel Common	\$200,000
New York City Bonds	150,000
	<hr/>
	\$350,000
Deduct indebtedness	300,000
	<hr/>
Excess deductible on Schedule C.....	<u>\$50,000</u>

PROBLEMS

It will be noted from the above that only stocks, bonds and other obligations (other than obligations of the United States), the dividends or interest from which is not subject to excess profits tax, are considered inadmissible assets. Whether or not such non-taxable income was actually received is immaterial; the test is, would such income if received be so taxable? If not, the assets are inadmissible, except that obligations of the United States are always admissible.

REFERENCES:

- 1917—Article 44, Regulations 41; Article 53, Regulations 41.
1918—Article 815, Regulations 45 Revised; Article 852, Regulations 45 Revised.

PROBLEM 6

Illustration of Inadmissibles for 1917 When Part of Them Are Sold During the Taxable Year

FACTS:

Corporation A on January 1, 1917, owned tax-exempt municipal bonds that cost \$200,000 which were sold on September 30, 1917. The following income was received as the result of the ownership of these bonds:

Interest	\$ 8,000 not taxable
Profit on sale	12,000 taxable
Total income	<u><u>\$20,000</u></u>

PROBLEM:

Compute the amount of inadmissible assets to be deducted under Schedule C, Form 1103.

FEDERAL CORPORATE INCOME TAXES

SOLUTION:

The taxable profit is $\frac{3}{5}$ of the total income received; therefore $\frac{3}{5}$ of \$200,000, or \$120,000, is considered an admissible asset, leaving \$80,000 to be treated as inadmissible assets.

As the bonds were sold on September 30, 1917, the average for the year of these inadmissible assets would be $\frac{9}{12}$ of \$80,000 or \$60,000.

Total tax-exempt bonds	\$200,000
Less admissible portion as above	120,000
	<hr/>
Portion treated as inadmissible assets	\$80,000
	<hr/>
Average inadmissible assets $\frac{9}{12}$ of \$80,000	\$60,000
Less average indebtedness	50,000
	<hr/>
Amount to be deducted in Schedule C	<u>\$10,000</u>

NOTE.—It is assumed that the average indebtedness for the year was \$50,000.

REFERENCE: Article 45, Regulations 41.

PROBLEM 7

*Illustration of Inadmissibles for 1917 Taking into
Consideration the Provision for Dis-
allowed Interest*

FACTS:

Corporation A submits the following data:

CORPORATION A

Balance Sheets

	December 31, 1917	January 1, 1917
<i>Assets:</i>		
Cash	\$200,000	\$200,000
Plant	400,000	400,000
Securities (inadmissible)	600,000	600,000
	<hr/>	<hr/>
	<u>\$1,200,000</u>	<u>\$1,200,000</u>

PROBLEMS

Liabilities:

Notes payable	\$400,000	\$600,000
Capital stock	200,000	200,000
Surplus	600,000	400,000
	<u>\$1,200,000</u>	<u>\$1,200,000</u>

During the year the corporation paid interest on indebtedness to the amount of \$30,000, but under Article 180, Regulations 33 Revised, it was allowed to deduct only \$24,000 on its income tax return, leaving \$6,000 not deductible.

PROBLEM:

Compute the deduction on account of the excess of inadmissible assets over indebtedness in Schedule C, Form 1103.

SOLUTION:

Under Article 44, Regulations 41, the amount to be included in invested capital on account of interest disallowed is that proportion of the permanent indebtedness which the amount of interest disallowed bears to the total interest paid, which in this case would be computed as follows:

$$\begin{array}{r} \text{Average indebtedness for the year} \dots\dots\dots \$500,000 \\ \text{Disallowed interest } \$6,000 \\ \hline \text{Total interest paid } \$30,000 \end{array} \times \$500,000 = \$100,000 *$$

* Amount restored in Schedule B.

COMPUTATION OF EXCESS OF INADMISSIBLES OVER INDEBTEDNESS

Indebtedness:

December 31, 1917	\$400,000
January 1, 1917	600,000

2| \$1,000,000

Average indebtedness \$500,000

FEDERAL CORPORATE INCOME TAXES

Average indebtedness (brought forward)	\$500,000
Deduct amount restored to invested capital in Schedule B	100,000
	<hr/>
Amount to apply against inadmissible assets	\$400,000
	<hr/>
Average inadmissible assets	\$600,000
Indebtedness as adjusted above	400,000
	<hr/>
Excess deducted in Schedule C	\$200,000
	<hr/>

It will be noted from the above that in computing the excess of inadmissible assets over indebtedness due consideration must be given to any adjustments made under Schedule B on account of additions to invested capital which are the result of disallowed interest.

See Articles 180 to 183, Regulations 33 Revised, as to the limitation upon and the method of computing the interest allowable as a deduction.

PROBLEM 8

Illustration of Method of Arriving at Interest Deduction Allowable in 1917 When Different Rates of Interest Were Paid, and the Additional Invested Capital Allowed Because of Interest Disallowed

Company A paid interest during the year 1917 to the amount of \$26,655.02. The interest-bearing indebtedness at the close of the year amounted to \$200,000, and the capital stock was \$200,000. Under Article 180, Regulations 33, the maximum principal upon which deductible interest may be computed is the capital stock, \$200,000, plus one-half of the interest-bearing indebtedness, or \$100,000, making the total maximum principal for this purpose \$300,000. In-

PROBLEMS

terest was paid on the indebtedness at different rates, from 4 per cent to 8 per cent. Using the above facts as a basis, the following schedule shows the amount of interest allowable as a deduction when interest is paid at different rates, and the amount to be restored to invested capital under Schedule B, Form 1103, in accordance with Article 44, Regulations 41.

Note that the limitation of interest as a deduction is that at *no time during the taxable year* may interest be taken as a deduction from gross income on a principal in excess of the statutory limitations. Where there are several rates of interest, the higher rates are applied first against maximum indebtedness allowed.

FEDERAL CORPORATE INCOME TAXES

Total interest paid for year 1917.....\$26,655.02.

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
						Total outstand- ing in- debtedness	Maximum principal allowable	Excess over maximum	No. of days	Interest disallowed	Average indebted- ness on daily basis
Date	4%	5%	6%	7%	8%	debtedness					
Jan. 1..				\$500,000	\$600,000	\$500,000	\$300,000	\$200,000	25	\$ 958.90	\$12,500,000
" 26..						600,000	"	300,000	109	7,167.12	65,400,000
May 15..	\$142,000				600,000	742,000	"	442,000	5	406.58	3,710,000
" 20..	142,000					142,000	"		51		7,242,000
July 10..							"		10		
" 20..					400,000	400,000	"	100,000	39	854.79	15,600,000
Aug. 28..			\$200,000		400,000	600,000	"	300,000	5	273.97	3,000,000
Sept. 2..			200,000			200,000	"		8		1,600,000
" 10..		\$90,000				290,000	"		54		15,660,000
Nov. 3..	100,000	90,000	200,000			390,000	"	90,000	29	286.03	11,310,000
Dec. 2..		90,000	200,000			290,000	"		1		290,000
" 3..			200,000			200,000	"		29		5,800,000
Totals ..											
									365	\$9,947.39	\$142,112,000
										Average	\$389,347.95

Formula for addition to invested capital because of disallowed interest as result of statutory limitations:

Disallowed interest (\$9,947.39)

Total interest paid (\$26,655.02) \times Average indebtedness (\$389,347.95) = Amount to be added to invested capital (\$145,300.81).

Column 11 = Interest on excess principal (column 9) for days outstanding (column 10) taking lowest rates first.
Column 12 = Column 7 multiplied by column 10.

PROBLEMS

PROBLEM 9

Illustrating Computation of Inadmissibles, 1918

FACTS:

Corporation A submits the following data:

CORPORATION A

Balance Sheets

	January 1, 1918	December 31, 1918
Assets:		
Cash	\$ 20,000	\$ 30,000
Plant	200,000	210,000
Accounts receivable	40,000	70,000
Securities (New York City Bonds)	100,000	100,000
	<u>\$360,000</u>	<u>\$410,000</u>
Liabilities:		
Accounts payable	\$ 80,000	\$ 90,000
Capital stock	200,000	200,000
Surplus	80,000	120,000
	<u>\$360,000</u>	<u>\$410,000</u>

Interest received (non-taxable)	\$ 8,000
Interest paid (not deductible)	2,000
Average inadmissible assets	100,000

PROBLEM:

Compute the deduction on account of inadmissible assets.

SOLUTION:

Average total assets for the year:

January 1, 1918	\$360,000
December 31, 1918	410,000
	<u>2 \$770,000</u>
Average total assets	\$385,000

FEDERAL CORPORATE INCOME TAXES

Amount of inadmissible assets to become admissible on account of interest paid but not deductible from net income is computed as follows:

$$\frac{2,000}{8,000} \times \$100,000 = \$25,000$$

The next step is to deduct from the inadmissible assets that portion which has been determined admissible:

Average inadmissible assets	\$100,000
Less admissible portion	25,000
	<hr/>
Balance inadmissible assets	\$ 75,000

The invested capital of the corporation is:

Schedule E:

Capital stock, January 1, 1918.....	\$200,000
Surplus, January 1, 1918	80,000
	<hr/>
Total	\$280,000.00

Less:

Schedule L:

Deduction on account of inadmissibles:	
Average inadmissibles, \$75,000	
Average total assets, \$385,000	$\times \$280,000 =$
	<hr/>
Invested capital	\$225,454.54

REFERENCES:

- Section 234 (a) (2) Revenue Act of 1918.
- Article 852, Regulations 45 Revised.
- Article 817, Regulations 45 Revised.

Reference is made to Article 852 of Regulations 45 Revised, which, it is to be noted, provides that in determining the total asset figures used in this computation, valuation reserves and other adjustments of assets for invested capital purposes, such as the limitation upon goodwill, are to be taken into consideration.

PROBLEMS

PROBLEM 10

Inadmissibles—Computation When Amounts Vary During Year

Corporations A and B filed a consolidated income and profits tax return for the calendar year ended December 31, 1918. They found their consolidated invested capital, exclusive of the deduction on account of inadmissible assets, to be as follows:

Capital stock	\$2,000,000
Surplus	2,674,000
Total	<u>\$4,674,000</u>

The following shows a method which is often employed in computing the amount to be deducted from invested capital on account of inadmissible assets held during the year, in case there are substantial changes either in admissible or inadmissible assets during the year.

As Shown by Consolidated Balance Sheet

Date	Total	Inadmissible
1918	Assets	Assets
January 1.....	\$5,178,000	\$435,800
February 1.....	5,168,000	525,800
March 1.....	5,241,000	574,000
April 1.....	5,302,000	574,000
May 1.....	5,318,000	756,500
June 1.....	5,312,000	788,500
July 1.....	5,546,000	788,500
August 1.....	5,739,000	880,500
September 1.....	5,912,000	903,100
October 1.....	6,143,592	903,100
November 1.....	6,306,620	981,600
December 1.....	6,194,000	1,044,200
December 31.....	5,949,000	1,044,200
Total	<u>\$73,309,212</u>	<u>\$10,199,800</u>
Average	5,639,170	784,600

$$\frac{784,600}{5,639,170} = 13.9\%$$

FEDERAL CORPORATE INCOME TAXES

The amount to be deducted is 13.9 per cent of \$4,-674,000, which is \$649,686.

The above computation is based on Article 852, Regulations 45 Revised.

PROBLEM 11

*Illustrating the Method of Computing the Amortization Deduction Allowed Under Section 214(a)
9 of the Revenue Act of 1918*

FACTS:

The Smith Machine Tool Company purchased and installed in its plants after April 5, 1917, sufficient machinery to double its former capacity in order to carry out the contracts which it had undertaken for the production of articles contributing to the prosecution of the war.

The cost of the additional machinery, installed ready to operate, was \$400,000. Installation of the additional machinery was completed July 1, 1917, and was placed in operation on the same day.

After the signing of the Armistice, the majority of the company's contracts were canceled, so that the capacity of its plants was far in excess of its requirements for operations on a normal peace basis.

One-half of the additional machinery which cost \$200,000 was sold February 1, 1919, for \$40,000, as the company had no further use for it. It estimated that one-fourth of the additional machinery, which cost \$100,000, would have to be discarded July 31, 1919, inasmuch as on that date the war facilities turned out by these machines would be completed; and it considered the balance of the additional machinery, which cost \$100,000, would be required to complete the war contracts which it estimated would take

PROBLEMS

until March 1, 1920. It estimated the salvage value of the machines to be discarded July 31, 1919, as \$25,000. As the company intended to continue to use the machines, which were to be operating on war contracts until March 1, 1920, on its post-war work, it estimated their "value in use," on the basis of post-war conditions, to be \$75,000, which amount was in excess of their saleable value. Depreciation on the above machines was computed at the rate of 10 per cent per annum.

PROBLEM:

Determine the amortization allowance the Smith Machine Tool Company is entitled to deduct on its returns for each of the taxable years, 1918, 1919 and 1920.

SOLUTION:

	<i>Group 1</i> Sold Feb. 1, 1919	<i>Group 2</i> To be Discarded July 31, 1919	<i>Group 3</i> Use to be Continued. Estimated Date of Completion of War Work March 1, 1920
Original cost	\$200,000	\$100,000	\$100,000
Depreciation to January 1, 1918	10,000	5,000	5,000
Depreciated cost, Janu- ary 1, 1918	\$190,000	\$95,000	\$95,000
Consideration received from sale	40,000		
Salvage value at discard date		25,000	
"Value in use"			75,000
Amount to be amortized	<u>\$150,000</u>	<u>\$70,000</u>	<u>\$20,000</u>

FEDERAL CORPORATE INCOME TAXES

	Group 1	Group 2	Group 3
Amortization period			
from January 1, 1918,			
to	Feb. 1, 1919	July 31, 1919	Mar. 1, 1920
	13 months	19 months	26 months
Estimated Earnings for			
Each Year during the			
Amortization Period			
1918	\$900,000	\$900,000	\$900,000
1919	100,000	600,000	700,000
1920			100,000
Total earnings	<u>\$1,000,000</u>	<u>\$1,500,000</u>	<u>\$1,700,000</u>

Amount of Amortization Allowed as a Deduction

For machinery sold Febru-			
ary 1, 1919:	In 1918	In 1919	In 1920
9/10 of \$150,000.....	\$135,000.00		
1/10 of \$150,000.....		\$15,000.00	
For machinery discarded			
July 31, 1919:			
9/15 of \$70,000.....	42,000.00		
6/15 of \$70,000.....		28,000.00	
For machinery in use until			
March 1, 1920, on war			
work:			
9/17 of \$20,000.....	10,588.24		
7/17 of \$20,000.....		8,235.29	
1/17 of \$20,000.....			\$1,176.47
Total amortization allow-			
ance	<u>\$187,588.24</u>	<u>\$51,235.29</u>	<u>\$1,176.47</u>

COMMENT:

The basis for the determination of the amortization allowance on machinery sold and also the machinery discarded, comes under subdivision (1) of Article 184 as amended, Regulations 45 Revised, whereas the machinery continued to be used on post-war work comes under subdivision (2) of Article 184 as amended, in determining the duration of the amorti-

PROBLEMS

zation period and the amount of amortization allowable.

The basis for the allocation of the amortization allowance as among the taxable years covered by the amortization period, in the case of the machinery sold and the machinery discarded, is set forth in subdivision (a) of Article 185 as amended, while the basis for the allocation of the amortization allowance for the machinery continued in use is set forth in subdivision (b) of Article 185 as amended.

PROBLEM 12

*Illustrating Method of Applying Claim for Net Loss,
in the Case of a Consolidated Return, Allowed Under Section 204 (b) of the Revenue Act of 1918—Article 1601
of Regulations 45 Revised*

FACTS:

Corporation A owned 100 per cent of the capital stock of Corporations B and C and in accordance with the provisions of Section 240 of the Revenue Act of 1918 filed a consolidated return for each of the years 1918 and 1919.

NET INCOME

1918

	Dividends Received	Non-taxable Interest	Taxable Income	
Corporation A			\$100,000	
Corporation B	\$150,000	\$25,000	— 200,000	(loss)
Corporation C			1,100,000	
Consolidated taxable net income.....			<u>\$1,000,000</u>	

FEDERAL CORPORATE INCOME TAXES

1919

	Dividends Received	Non-taxable Interest	Taxable Income
Corporation A			\$200,000
Corporation B	\$150,000	\$25,000	— 600,000 (loss)
Corporation C			100,000
Consolidated net income (<i>loss</i>)			<u>— \$300,000</u>

QUESTION 1:

What relief is the taxpayer entitled to under the Revenue Act of 1918?

QUESTION 2:

Assuming that the net taxable income of Corporation C was only \$135,000 in 1918, how should the matter be handled?

ANSWER TO QUESTION 1:

Article 1601 of Regulations 45 Revised states that a loss to be the subject of a claim for adjustment "must represent an actual net loss over and above all income, including tax-free income." The consolidated net loss of \$300,000 for the year 1919 must therefore be adjusted for the purpose of the "net-loss" provision as follows:

Consolidated net loss—1919	\$300,000
<i>Less</i>	
Dividends received	\$150,000
Tax-free interest	25,000
	<u>175,000</u>
Adjusted net loss—1919	\$125,000
Consolidated net income—1918	\$1,000,000
Adjusted net loss—1919	125,000
	<u>—</u>
Corrected consolidated net income for 1918—for the purpose of recomputing taxes due for 1918	<u><u>\$875,000</u></u>

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ANSWER TO QUESTION 2:

Based on the assumption that the net taxable income of Corporation C in 1918 was only \$135,000, the consolidated taxable net income for that year would be \$35,000.

Adjusted net loss—1919	\$125,000
Consolidated net taxable income—1918	35,000
	<hr/>
Amount to be claimed as a deduction against 1920 income	\$90,000

It is to be noted that the net-loss provision is applicable only in the case of a taxpayer having a taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, in accordance with Section 204, 1918 Act, and Articles 1601-1603 of Regulations 45 Revised.

PROBLEM 13

*Illustrating the Method of Arriving at the Allowance
for Obsolescence of Goodwill, Trade-marks
and Trade Brands in the Case of
Distillers, Dealers in Liquors, etc.*

FACTS:

The X Brewing Company acquired goodwill in January, 1914, for \$500,000 in cash. It went out of business on January 16, 1920 (effective date of the 18th Constitutional Amendment). Its net income between January 31, 1918, and January 16, 1920, was \$600,000. The present worth at January 31, 1918, of the income which it was expected would be derived from the goodwill in the period from January 31, 1918, to January 16, 1920, was \$300,000. The Company filed

FEDERAL CORPORATE INCOME TAXES

returns for the years ending December 31, 1918, and December 31, 1919, and the period from January 1 to January 16, 1920.

PROBLEM:

State fully on what basis the depreciation on the intangibles may be computed and how much depreciation will be allowed as a deduction in each of the returns mentioned above.

SOLUTION:

In view of the status of prohibition legislation on January 31, 1918, upon that date the value of the goodwill of distillers, brewers, etc., was reduced to the then present value of the income to be derived therefrom between that date (January 31, 1918) and January 16, 1920. The value of the goodwill on January 31, 1918, is apportioned on the basis of the time elapsed between that date and January 16, 1920 (the date upon which prohibition became effective). The value on January 31, 1918, is based upon the net income to be realized between January 31, 1918, and January 16, 1920. The difference between the cost of the goodwill and the value on January 31, 1918 (as measured by the value of the earnings to be subsequently realized), represents the amount by which goodwill has depreciated as at January 31, 1918. This entire amount is deductible in the first taxable year ending on or after January 31, 1918. The remainder must be equitably apportioned between January 31, 1918, and January 16, 1920, based on time only. The depreciation on the value of the goodwill on January 31, 1918, is deductible as follows:

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The actual value on January 31, 1918, of the net income to be derived from the goodwill was \$300,000. This amount, therefore, represents the value of the goodwill as at January 31, 1918. The difference between this amount and \$500,000 represents the depreciation which had fully accrued on January 31, 1918 (\$200,000). This \$200,000 is deductible in the first taxable year ending on or after January 31, 1918; in this case December 31, 1918. The remaining \$300,000 is deductible as follows:

$$\frac{11}{23\frac{1}{2}} \times \$300,000 = \$140,425.54 \text{ for the taxable year 1918.}$$

$$\frac{12}{23\frac{1}{2}} \times \$300,000 = \$153,191.48 \text{ for the taxable year 1919.}$$

$$\frac{\frac{1}{2}}{23\frac{1}{2}} \times \$300,000 = \$ 6,382.98 \text{ for period Jan. 1 to Jan. 16, 1920.}$$

\$300,000.00

1918 taxable year 200,000.00

\$500,000.00

Amounts to be written off in 1918: \$200,000.00
140,425.54

Amount to be written off in 1919:

Amount to be written off in 1920:

\$340,425.54

153,191.48

6,382.98

\$500,000.00

NOTE:—The value of the goodwill on January 31, 1918, is prorated on the basis of the portion of the interval in each taxable year between January 31, 1918, and January 16, 1920, or eleven months for 1918, twelve months for 1919 and one-half month for 1920, making a total of 23½ months.

REFERENCE: Treasury Decision 2929, dated October 7, 1919, amending Article 163, Regulations 45 Revised.

FEDERAL CORPORATE INCOME TAXES

PROBLEM 14

Illustrating Application of Section 330 of the Revenue Act of 1918 to the Pre-war Period

FACTS:

Company A was organized January 1, 1900, and conducted a retail shoe business. In 1916 Company A was reorganized and Company X was formed to take over the business of Company A. The reorganized Company X issued capital stock for the goodwill of Company A to the amount of \$200,000 par, which was the cash value of the goodwill at the date of acquisition. Although Company A had no goodwill account on the books nor had at any time specifically purchased goodwill with cash, tangible property or capital stock, the actual cash value of Company A's goodwill during the pre-war period was \$150,000. The total capital stock of Company X outstanding both on March 3, 1917, and January 1, 1918, was \$400,000.

QUESTION:

Has Company X a pre-war period? If so, at what value should its goodwill be included in invested capital for the pre-war years?

ANSWER:

Since Company X carries on a business which is a continuation of Company A's business, Company X is deemed to have been in existence during the pre-war period and the net income and invested capital (within certain limitations set forth in the last paragraph of Section 330) of Company A for all of the pre-war period is considered to have been the net in-

PROBLEMS

come and invested capital of Company X. The goodwill of Company X for the taxable year 1918 is subject to the limitations of Section 326 (a) 4 of the 1918 law, since it was acquired with stock and the amount of goodwill allowable as invested capital is computed as follows:

Capital stock outstanding March 3, 1917, and January 1, 1918	\$400,000
25% of above amount	100,000

As the cash value of the goodwill at the date of acquisition thereof by Company X was in excess of the above amount, goodwill to the amount of \$100,000 may be included in invested capital for the taxable year.

Although Company A had no goodwill on its books during the pre-war period, it had developed a goodwill asset which had a cash value of \$150,000 during the pre-war period; therefore, since the goodwill asset was in existence during both the taxable year and the pre-war period, such readjustments should be made as are necessary to place the computation of the invested capital for such pre-war years on the basis employed in determining the invested capital for the taxable year, in accordance with Section 330 of the Revenue Act of 1918 and Article 934 of Regulations 45 Revised.

Therefore, Company X should include goodwill in its invested capital for the pre-war period to the amount of \$100,000.

FEDERAL CORPORATE INCOME TAXES

PROBLEM 15

Illustrating Basis for Arriving at Income and Excess Profits Tax Installments for Invested Capital Purposes Only

FACTS:

Corporation A had a fiscal year ending July 31, and filed its 1918 return on the basis of such fiscal year. The total income and excess profits tax assessable under the 1917 law is \$275,000, while the additional tax assessable under the 1918 law is \$125,000, giving a total tax assessable for the year ended July 31, 1918, amounting to \$400,000.

QUESTION:

For the purpose of computing invested capital for the fiscal year ended July 31, 1919, when would the income and excess profits taxes for the fiscal year ended July 31, 1918, be deemed to become due and payable?

ANSWER:

The total tax for the purpose of computing invested capital will be deemed to become due and payable as follows:

- \$275,000 on January 12, 1919—which is 165 days from the close of the fiscal year, being the due date of the payment of the tax under the 1917 law.
- 25,000 on April 15, 1919—date of the third installment under the 1918 law.
- 100,000 on July 15, 1919—date of the fourth installment under the 1918 law.

It should be noted that amounts which became due and payable under the 1917 Act prior to February 25, 1919, are as far as possible, deemed to have canceled

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earlier installments payable under Section 250 of the 1918 Act. Therefore the first installment which would have become due October 15, 1918, under the 1918 Act has been canceled. In addition the amount of \$275,000 due under the 1917 Act takes care of the installment of \$100,000 which would have become due on January 15, 1919, under the Revenue Act of 1918, and also takes care of \$75,000 of the installment which would have become due on April 15, 1919, under the Revenue Act of 1918.

QUESTION:

If the return of Corporation A were filed for the fiscal year ended September 30, 1918, and the tax assessed were the same as stated in the above proposition, when would the taxes be deemed to become due and payable for invested capital purposes?

ANSWER:

\$100,000 on February 25, 1919—in accordance with the provisions of Treasury Decision 2931.

100,000 on March 15, 1919—date of second installment.

100,000 on June 15, 1919—date of third installment.

100,000 on September 15, 1919—date of fourth installment.

Section 14(a) of the Revenue Act of 1916 provides, in effect, that the taxes of concerns filing on a fiscal year basis shall become due and payable 165 days from the closing date of the fiscal year. The tax of \$275,000 due under the 1917 Act, based upon Section 14(a), would become due and payable March 14, 1919. However, Treasury Decision 2931 and Article 845(a) of Regulations 45 Revised, stipulate that while in the case of amounts due and payable prior to February 25, 1919, under the provisions of Section 14(a) of

FEDERAL CORPORATE INCOME TAXES

the Revenue Act of 1916, such law shall govern, in all other respects the provisions of Section 250 of the Revenue Act of 1918 shall govern, except that the installments which would have become due prior to February 25, 1919, shall be deemed to become due and payable on that date. Therefore, since the tax of \$275,000 would have become due after February 25, 1919, in accordance with Section 14(a) of the Revenue Act of 1916, Section 250 of the Revenue Act of 1918 governs, except that the first installment which under Section 250 would ordinarily have become due and payable the fifteenth day of the third month from the end of the fiscal year, or December 15, 1918, is deemed to have become due and payable February 25, 1919. The other three installments are deemed to have become due strictly in accordance with the requirements of Section 250.

See Problem 16 for method of prorating the installments for invested capital purposes.

PROBLEM 16

Illustrating Method of Prorating Installments of Income and Profits Tax in Arriving at Invested Capital for 1919

FACTS:

The income and profits taxes for 1918 of Corporation A amounted to \$100,000, and were paid in four installments as follows:

\$25,000 on March 15, 1919.
25,000 on June 15, 1919.
25,000 on September 15, 1919
25,000 on December 15, 1919.

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PROBLEM :

From the above facts compute the amount to be deducted from invested capital for 1919 in Schedule H, Form 1120.

SOLUTION :

Article 845, Regulations 45 Revised, states that amounts payable on account of the above taxes may be included in invested capital only until such taxes become due and payable.

\$25,000 prorated for 292 days (March 15 to December 31)	= \$20,000.00
\$25,000 prorated for 200 days (June 15 to December 31)	= 13,698.63
\$25,000 prorated for 108 days (September 15 to December 31)	= 7,397.26
\$25,000 prorated for 17 days (December 15 to December 31)	= 1,164.38
Total to be deducted in Schedule H.....	\$42,260.27

It is immaterial whether or not the full tax is paid on March 15, or whether the actual payments are different from the installments that would be due on the four installment dates. The deductions from invested capital are based on the installments as of the date each is *due and payable*.

Inasmuch as the corporation was reporting on the calendar-year basis, the shorter method referred to in Chapter IV may be applied here, i. e., the deduction will be 42.260274 per cent of the total taxes payable.

Thus:

$$\$100,000 \times .42260274 = \$42,260.27$$

REFERENCE: Article 845, Regulations 45 Revised.

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PROBLEM 17

Intercompany Transaction Affecting Consolidated Net Income

FACTS:

Company A, a chemical company, owns 100 per cent of the stock of Company B, a paint manufacturing company. These two companies were required to file consolidated returns in 1917. In 1915 Company A had purchased \$100,000 par value of New York City bonds at a total price of \$104,000. During the taxable year 1917, Company A sold these bonds to its subsidiary at a price of \$96,000.

QUESTION:

May Company A deduct a loss of \$8,000 in its income and excess profits tax returns for 1917?

ANSWER:

Company A may deduct the loss of \$8,000 in its income tax return for 1917. However, it may not deduct this loss in ascertaining the consolidated net income for excess profits tax purposes. That is, for computing consolidated net income the transaction given above will be considered an intercompany transaction. When the stock is finally sold by Company B to outside interests a profit or loss will be sustained for the purpose of computing consolidated net income.

NOTE:—Had this transaction occurred in 1918, or subsequent years, the loss of \$8,000 would not be deductible for income or profits tax purposes, because in 1918 both income taxes and profits taxes of affiliated companies are computed on the basis of consolidated net income.

PROBLEMS

PROBLEM 18

Computation of Invested Capital—Adjustment of Intercompany Inventory

FACTS:

Corporation A, a foundry, and Corporation B, which manufactures steam pumps and engines, are owned and controlled by the same interests and are required to file a consolidated return.

The following data are submitted:

CORPORATION A

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 60,000	Accounts payable ..	\$120,000
Inventories	60,000	Capital stock	200,000
Municipal Bonds ...	125,000	Surplus	180,000
Plant	150,000		
Goodwill	105,000		
	<u>\$500,000</u>		<u>\$500,000</u>

CORPORATION B

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 20,000	Notes payable	\$105,000
Inventories	55,000	Capital stock	250,000
Municipal Bonds ...	100,000	Surplus	95,000
Plant	150,000		
Goodwill	125,000		
	<u>\$450,000</u>		<u>\$450,000</u>

The goodwill of Corporation A was acquired with capital stock and at the date of acquisition had a cash value of \$35,000.

The goodwill of Corporation B was acquired for \$75,000 cash.

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The inventory of Corporation B was purchased from Corporation A on cost plus 10 per cent basis, and was inventoried by Corporation B at the cost price to it.

PROBLEM :

From the above data, compute the invested capital for 1917.

SOLUTION :

The consolidated balance sheet is prepared as follows:

	Corpora- tion A	Corpora- tion B	Elimina- tions	Consoli- dated Balance Sheet
<i>Assets:</i>				
Cash	\$ 60,000	\$ 20,000		\$ 80,000
Inventories	60,000	55,000	\$5,000	110,000
Municipal Bonds.	125,000	100,000		225,000
Plant	150,000	150,000		300,000
Goodwill	105,000	125,000		230,000
	<u>\$500,000</u>	<u>\$450,000</u>	<u>\$5,000</u>	<u>\$945,000</u>
<i>Liabilities:</i>				
Accounts payable	\$120,000			\$120,000
Notes payable ..		\$105,000		105,000
Capital stock ...	200,000	250,000		450,000
Surplus	180,000	95,000	\$5,000	270,000
	<u>\$500,000</u>	<u>\$450,000</u>	<u>\$5,000</u>	<u>\$945,000</u>

The invested capital is computed as follows:

Schedule A:		
Capital stock consolidated balance sheet	\$450,000	
Surplus	270,000	
		<u>\$720,000</u>
Schedule C:		
Deductions:		
Goodwill Corporation A.....	\$70,000	
Goodwill Corporation B.....	50,000	120,000
		<u>120,000</u>
Consolidated invested capital.....		<u>\$600,000</u>

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In the above consolidated balance sheet, there has been eliminated the 10 per cent intercompany profit in the inventory of Corporation B, which amounts to \$5,000. This elimination is made by crediting inventories and charging surplus.

No adjustment was necessary in invested capital on account of inadmissible assets, inasmuch as the inadmissible assets do not exceed the indebtedness.

If the above computation of invested capital were for 1918, the deduction on account of inadmissible assets would be the percentage of \$600,000 that the average inadmissible assets for the year bear to the total average assets (properly valued) for the year.

As the goodwill of Corporation A was acquired with stock, it would seem at first glance that it is subject to the 20 per cent limitation. However, the cash value of this goodwill on the date of acquisition was \$35,000, which is \$5,000 lower than 20 per cent of the outstanding stock \$200,000, and as the Regulations require that the lower amount be used, the amount of goodwill to be disallowed is computed as follows:

Goodwill of Corporation A.....	\$105,000
Less cash value of same.....	35,000
	<hr/>
Amount disallowed as invested capital.....	\$70,000

The goodwill of Corporation B was acquired for \$75,000 cash, and cannot be included in invested capital at an amount in excess of the cost price. The 20 per cent limitation does not apply in cases where goodwill was acquired for cash. The amount of goodwill disallowed in the case of Corporation B is computed as follows:

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Goodwill of Corporation B.....	\$125,000
Less cash consideration paid for same.....	75,000
	<u>50,000</u>
Appreciation of goodwill disallowed.....	<u>\$50,000</u>

REFERENCES:

- Article 57, Regulations 41.
- Article 60, Regulations 41.
- Article 864, Regulations 45 Revised.
- Article 865, Regulations 45 Revised.

PROBLEM 19

Consolidated Invested Capital—Inadmissibles—1917

FACTS:

Corporations A and B, investment companies, are owned and controlled by the same interests in the same proportions and are required to file a consolidated excess profits tax return.

The balance sheet of Corporation A as at January 1, 1917, was as follows:

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$40,000	Accounts payable ...	\$10,000
Domestic corporate stock	60,000	Capital stock	50,000
	<u>\$100,000</u>	Surplus	40,000
			<u>\$100,000</u>

The balance sheet of Corporation B on the same date was as follows:

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$25,000	Accounts payable ...	\$25,000
Domestic corporate stock	35,000	Capital stock	25,000
	<u>\$60,000</u>	Surplus	10,000
			<u>\$60,000</u>

PROBLEMS

PROBLEM :

Assuming that the stocks owned and the indebtedness remained constant throughout the year, and that no additional capital was taken into either corporation, compute the consolidated invested capital of the companies.

SOLUTION :

The first step will be to set up a consolidated balance sheet as at January 1, 1917. Inasmuch as the above balance sheets contain no intercompany accounts, and as they are consolidated as a "brother and brother" group, there will be no eliminations to make. The consolidated balance sheet will merely be the above balance sheets combined as follows:

	Corpora- tion A	Corpora- tion B	Consolidated Balance Sheet
<i>Assets:</i>			
Cash	\$ 40,000	\$25,000	\$ 65,000
Domestic stocks	60,000	35,000	95,000
Totals	<u>\$100,000</u>	<u>\$60,000</u>	<u>\$160,000</u>
<i>Liabilities:</i>			
Accounts payable	\$ 10,000	\$25,000	\$ 35,000
Capital stock	50,000	25,000	75,000
Surplus	40,000	10,000	50,000
Totals	<u>\$100,000</u>	<u>\$60,000</u>	<u>\$160,000</u>

The consolidated invested capital for 1917 is computed as follows:

Schedule A:

Capital stock—consolidated balance sheet	\$ 75,000
Surplus—consolidated balance sheet	50,000
	<u>\$125,000</u>

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Schedule C:

Adjustment on account of excess of inadmissible
assets over indebtedness:

Domestic stocks	\$95,000	
Liabilities	35,000	60,000

Consolidated invested capital		\$65,000
-------------------------------------	--	----------

The excess of inadmissible assets over indebtedness is computed on the basis of the consolidated balance sheet in all consolidated cases. In cases where the indebtedness and inadmissibles vary materially throughout the year, the average for the year should be computed in some satisfactory manner other than by simply taking the sum of the balances at the beginning and end of the year and dividing by two.

It is assumed that the domestic stocks owned did not represent such control or ownership of other corporations as to warrant including such other corporations in this consolidation.

PROBLEM 20

Affiliated Corporations—Class B—Goodwill Limitation 1917 and 1918

FACTS:

Part I

Corporations A and B are engaged in the wholesale produce business and are owned and controlled by the same interests in substantially the same proportion.

The following data are submitted:

CORPORATION A

Balance Sheet as at January 1, 1917

Assets		Liabilities	
Cash	\$50,000	Accounts payable ...	\$10,000
Goodwill	50,000	Capital stock	50,000
		Surplus	40,000
	\$100,000		\$100,000
	\$100,000		\$100,000

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CORPORATION B

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$75,000	Accounts payable ...	\$25,000
Goodwill	75,000	Capital stock	75,000
		Surplus	50,000
	<u>\$150,000</u>		<u>\$150,000</u>

PROBLEM :

Assuming that the goodwill of Corporation A was purchased with cash and the goodwill of Corporation B acquired with stock at par, compute the consolidated invested capital of the companies as at January 1, 1917.

SOLUTION :

The first step, as explained in Problem 19, will be to set up a consolidated balance sheet as at January 1, 1917, as follows:

	Corpora- tion A	Corpora- tion B	Consolidated Balance Sheet
<i>Assets:</i>			
Cash	\$ 50,000	\$ 75,000	\$125,000
Goodwill	50,000	75,000	125,000
	<u>\$100,000</u>	<u>\$150,000</u>	<u>\$250,000</u>
<i>Liabilities:</i>			
Accounts payable ...	\$ 10,000	\$ 25,000	\$ 35,000
Capital stock	50,000	75,000	125,000
Surplus	40,000	50,000	90,000
	<u>\$100,000</u>	<u>\$150,000</u>	<u>\$250,000</u>

The consolidated invested capital for 1917 is computed as follows:

Schedule A:

Capital stock, consolidated balance sheet	\$125,000
Surplus, consolidated balance sheet	90,000
	<u>\$215,000</u>

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Schedule C:

Adjustment on account of 20% limitation on goodwill of Corporation B	60,000
Consolidated invested capital	<u>\$155,000</u>

In this class of consolidation, the "brother and brother" relation, the percentage limitation of goodwill is computed on the basis of the outstanding capital stock of each individual company.

As the goodwill of Corporation A was acquired with cash, the entire amount may properly be included in invested capital. The goodwill of Corporation B, however, was acquired with stock and is therefore subject to the limitation on intangible property as stated in Articles 57 and 58, Regulations 41. In this particular case, it is assumed that the cash value of the goodwill of Corporation B is at least equal to 20 per cent of the outstanding capital stock of the company on March 3, 1917. This limitation is computed as follows:

Goodwill of Corporation B	\$75,000
Less 20% of capital stock of Corporation B, i.e., 20% of \$75,000	<u>15,000</u>
Amount of goodwill disallowed as invested capital....	<u><u>\$60,000</u></u>

Part II

Assuming that the balance sheets given in Part I are dated January 1, 1918, compute the amount of goodwill to be disallowed as invested capital for the year 1918.

SOLUTION:

The only difference in this computation and the 1917 computation is the change in the percentage of the limitation. Under the Revenue Act of 1918, the

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limitation on intangible property is 25 per cent of the outstanding capital stock of the corporation at the beginning of the taxable year, in cases where such property was acquired after March 3, 1917. In cases where the property was acquired prior to March 3, 1917, the limitation is 25 per cent of the outstanding capital stock on March 3, 1917, provided the total amount acquired before and after March 3, 1917, and as limited in the foregoing, does not exceed in the aggregate 25 per cent of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year. This limitation is to be used only when the amount after applying such limitation is lower than the actual cash value at the date of acquisition of the property, or the par value of the stock or shares issued in payment for same.

Assuming that the cash value is more than 25 per cent of the capital stock outstanding, and that the goodwill was acquired prior to March 3, 1917, the amount of goodwill to be disallowed as invested capital is computed as follows:

Goodwill of Corporation B.....	\$75,000
Less 25% of capital stock of Corporation B outstanding on March 3, 1917, and at beginning of taxable year, i.e., 25% of \$75,000.....	18,750
Goodwill disallowed as invested capital.....	<u><u>\$56,250</u></u>

REFERENCES:

- 1917—Articles 57 and 58, Regulations 41.
- 1918—Article 865, Regulations 45 Revised.
- Section 326-A-4 and 5, Revenue Act of 1918.

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PROBLEM 21

Consolidated Invested Capital—Elimination of Inter-company Transactions

FACTS:

Corporation A, a tannery, and Corporation B, a shoe factory, are owned and controlled by the same individuals in the same proportion.

The following data are submitted:

CORPORATION A

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Plant	\$ 75,000	Accounts payable ..	\$ 50,000
Accounts receivable.	15,000	Capital stock	100,000
Due from Corp. B..	25,000	Surplus	50,000
Municipal bonds ...	75,000		
Cash	10,000		
	\$200,000		\$200,000

CORPORATION B

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Plant	\$ 90,000	Due Corp. A.....	\$ 25,000
Accounts receivable.	30,000	Capital stock	150,000
Municipal bonds ...	80,000	Surplus	75,000
Cash	50,000		
	\$250,000		\$250,000

PROBLEM:

Assuming that the bonds and indebtedness of both corporations remain constant throughout the year, compute the invested capital for 1917.

SOLUTION:

The consolidated balance sheet will be as follows:

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	Corpora- tion A	Corpora- tion B	Elimina- tions	Consoli- dated Balance Sheet
<i>Assets:</i>				
Plant	\$ 75,000	\$ 90,000		\$165,000
Accounts rec. ...	15,000	30,000		45,000
Due from Corp. B	25,000		\$25,000	
Municipal bonds.	75,000	80,000		155,000
Cash	10,000	50,000		60,000
	<u>\$200,000</u>	<u>\$250,000</u>	<u>\$25,000</u>	<u>\$425,000</u>

	Corpora- tion A	Corpora- tion B	Elimina- tions	Consoli- dated Balance Sheet
<i>Liabilities:</i>				
Accounts payable	\$ 50,000			\$ 50,000
Due Corp. A....		\$ 25,000	\$ 25,000	
Capital stock ...	100,000	150,000		250,000
Surplus	50,000	75,000		125,000
	<u>\$200,000</u>	<u>\$250,000</u>	<u>\$ 25,000</u>	<u>\$425,000</u>

The consolidated invested capital for 1917 is computed as follows:

Schedule A:

Capital stock, consolidated balance sheet	\$250,000
Surplus, consolidated balance sheet	125,000
	<u>\$375,000</u>

Schedule C:

Excess of inadmissibles over indebted- ness:		
Municipal bonds, consolidated bal- ance sheet	\$155,000	
Indebtedness	50,000	105,000
		<u>105,000</u>
Consolidated invested capital		<u>\$270,000</u>

The invested capital for 1918 would be computed in the same manner, with the exception that the deduction on account of inadmissible assets, under

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Schedule L, would be that percentage of the invested capital before making the adjustment on account of inadmissibles which the average inadmissible assets is of the total of the average admissible and inadmissible assets held during the year.

The outstanding feature of this problem, however, is the elimination of intercompany accounts.

In the preparation of a consolidated balance sheet it is necessary to eliminate all intercompany accounts, which may arise, for example, when one affiliated company sells to another, and the seller records the transaction as an account receivable, while the buyer records it as an account payable.

From the viewpoint of the enterprise as a whole or as a single unit, no actual change in the assets or liabilities is brought about by this transaction, and the entries made on the books inflate the assets and liabilities of the group. Therefore, it is necessary, in the above problem to eliminate from the assets of Corporation A the \$25,000 due from Corporation B and to eliminate from the liabilities of Corporation B the \$25,000 due Corporation A, thus making the consolidated balance sheet show only the true assets and liabilities of the consolidated group.

REFERENCES:

Article 864, Regulations 45 Revised.

Section 326(c), Revenue Act of 1918.

PROBLEM 22

Computation of Invested Capital—Class A Consolidation

FACTS:

Corporation A, a newspaper, organized Corporation B, a job printing company, in 1914 by paying \$100,-

PROBLEMS

000 cash for the entire capital stock, of a par value of \$100,000.

The following data are submitted:

CORPORATION A

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 25,000	Accounts payable ..	\$100,000
Accounts receivable.	65,000	Capital stock	400,000
Securities	200,000	Surplus	190,000
Treasury stock	100,000		
Plant	200,000		
Goodwill	100,000		
	\$690,000		\$690,000

CORPORATION B

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 10,000	Notes payable	\$120,000
Accounts receivable.	60,000	Capital stock	100,000
Securities	30,000	Surplus	140,000
Plant	80,000		
Goodwill	180,000		
	\$360,000		\$360,000

The securities of Corporation A are as follows:

United States Government bonds	\$ 25,000
Municipal bonds	75,000
Stock of Corporation B	100,000

The securities of Corporation B are as follows:

Municipal bonds	\$ 30,000
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The goodwill of Corporation A was acquired with stock.

The goodwill of Corporation B was acquired with cash.

It is assumed that the amount of securities and indebtedness remained constant during the year.

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PROBLEM:

From the above data, compute the invested capital as at January 1, 1917, and explain each adjustment made.

SOLUTION:

Consolidated Balance Sheet

	Corpora- tion A	Corpora- tion B	Elimina- tions	Consoli- dated Balance Sheet
<i>Assets:</i>				
Cash	\$ 25,000	\$ 10,000		\$ 35,000
Accounts receivable	65,000	60,000		125,000
Securities	200,000	30,000	\$100,000	130,000
Treasury stock ..	100,000			100,000
Plant	200,000	80,000		280,000
Goodwill	100,000	180,000		280,000
	<u>\$690,000</u>	<u>\$360,000</u>	<u>\$100,000</u>	<u>\$950,000</u>
<i>Liabilities:</i>				
Accounts payable	\$100,000			\$100,000
Notes payable ..		\$120,000		120,000
Capital stock ...	400,000	100,000	\$100,000	400,000
Surplus	190,000	140,000		330,000
	<u>\$690,000</u>	<u>\$360,000</u>	<u>\$100,000</u>	<u>\$950,000</u>

As the investment of Corporation A in the capital stock of Corporation B is also reflected in the net worth of Corporation B, the capital stock of Corporation B is eliminated from the investment account of Corporation A, and offsetting this amount the capital stock of Corporation B is also eliminated, in the preparation of the consolidated balance sheet.

The invested capital of the consolidation is as follows:

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Schedule A:

Capital stock, consolidated balance sheet	\$400,000	
Less: Treasury stock	100,000	\$300,000
		<hr/>
Surplus, consolidated balance sheet...		330,000
		<hr/>
		\$630,000

Schedule C:

Goodwill, Corporation A.....	40,000	
		<hr/>
Consolidated invested capital	\$590,000	
		<hr/> <hr/>

As the goodwill of Corporation A was acquired with stock, assuming that the cash value is more than 20 per cent of the outstanding capital stock, the latter limitation must be applied. In a consolidation of this kind, the "parent and child" relation, the limitation of goodwill is computed as follows:

Goodwill of Corporation A	\$100,000	
Less:		
20% of the consolidated outstanding capital stock (20% of \$300,000)	60,000	
		<hr/>
Goodwill disallowed as invested capital	\$ 40,000	

The goodwill of Corporation B was acquired with cash, and under Article 60, Regulations 41, may be included in invested capital.

The inadmissible assets in a "parent and child" consolidation are treated in the same manner as in a "brother and brother" consolidation, i. e., based on the consolidated balance sheet.

In this problem the inadmissible assets are as follows:

Municipal bonds	\$105,000
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It should be noted that the United States Government Bonds are admissible assets.

Inasmuch as the consolidated indebtedness of the corporations is \$220,000, and is therefore in excess of

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the inadmissible assets, there is no adjustment because of the ownership of so-called inadmissible assets.

The characteristic feature of this problem is the elimination of the stock of a subsidiary corporation acquired with cash at par.

REFERENCES:

- Treatment of Goodwill Acquired with Cash—Problem 18.
- Treatment of Goodwill Acquired with Stock—Problem 18.
- Treatment of Inadmissible Assets—Problem 19.
- Article 867, Regulations 45 Revised.

PROBLEM 23

Computation of Consolidated Invested Capital When Subsidiary is Acquired for Cash at a Discount

FACTS:

Corporation A, a paper mill, acquired the stock of Corporation B, a sulphite mill, January 1, 1914, for a cash consideration of \$100,000. The goodwill of Corporation A was acquired by it with stock.

CORPORATION A

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Accounts receivable.	\$110,000	Accounts payable ..	\$200,000
Due from Corp. B..	90,000	Capital stock	400,000
Stocks and bonds,		Surplus	200,000
domestic	300,000		
Plant	200,000		
Goodwill	100,000		
	<u>\$800,000</u>		<u>\$800,000</u>

CORPORATION B

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Accounts receivable.	\$120,000	Due Corp. A.....	\$ 90,000
Stocks, domestic ...	20,000	Capital stock	100,000
Plant	80,000	Surplus	210,000
Goodwill	180,000		
	<u>\$400,000</u>		<u>\$400,000</u>

PROBLEMS

The securities owned by Corporation A are as follows:

Stocks of domestic corporations	\$190,000
United States Steel bonds	10,000
Stock of Corporation B.....	100,000
	<u>\$300,000</u>

The stocks owned by Corporation B are as follows:

Stocks of domestic corporations	\$20,000
---------------------------------------	----------

CORPORATION B

Balance Sheet as at January 1, 1914, Date of Acquisition by Corporation A

<i>Assets</i>		<i>Liabilities</i>	
Tangible property ..	\$200,000	Accounts payable ...	\$240,000
Intangible property.	180,000	Capital stock	100,000
		Surplus	40,000
	<u>\$380,000</u>		<u>\$380,000</u>

PROBLEM:

Assuming that the indebtedness and stocks remained constant during the year, compute the invested capital for 1917.

SOLUTION:

The consolidated balance sheet may be set up as follows:

<i>Assets:</i>	Corpora- tion A	Corpora- tion B	Elimina- tions	Consoli- dated Balance Sheet
Accounts receivable	\$110,000	\$120,000		\$230,000
Due from Corp. B	90,000		\$ 90,000	
Stocks	300,000	20,000	100,000	220,000
Plant	200,000	80,000		280,000
Goodwill	100,000	180,000	40,000	240,000
	<u>\$800,000</u>	<u>\$400,000</u>	<u>\$230,000</u>	<u>\$970,000</u>

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Liabilities:

Accounts payable	\$200,000			\$200,000
Due Corp. A ...		\$ 90,000	\$ 90,000	
Capital stock ...	400,000	100,000	100,000	400,000
Surplus	200,000	210,000	40,000	370,000
	<u>\$800,000</u>	<u>\$400,000</u>	<u>\$230,000</u>	<u>\$970,000</u>

The invested capital is computed as follows:

Schedule A:

Capital stock, consolidated balance sheet.....	\$400,000
Surplus, consolidated balance sheet	370,000
	<u>\$770,000</u>

Schedule C:

Goodwill of Corporation A..	\$100,000		
20% of \$400,000	80,000		
	<u> </u>	\$20,000	
Excess of inadmissible assets:			
Total inadmissibles	\$210,000		
Less indebtedness	200,000	10,000	30,000
	<u> </u>	<u> </u>	<u> </u>
Consolidated invested capital			<u>\$740,000</u>

Assuming that the cash value of the goodwill of Corporation A as at the date of its acquisition is in excess of \$80,000, the adjustments on account of goodwill and inadmissible assets are computed in the manner outlined in Problems 18 and 19, respectively.

The adjustment on account of intercompany transactions is outlined in Problem 21.

The characteristic of this problem is the elimination of the stock of a subsidiary corporation acquired for cash at a discount.

As Corporation A acquired the entire capital stock of Corporation B for \$100,000, the cash paid for same must be the amount at which it is taken into the consolidation. It is, therefore, necessary in this case to eliminate the amount by which the net assets of

PROBLEMS

Corporation B at date of acquisition exceed \$100,000, which is \$40,000. This amount is as a rule eliminated first against intangibles, and if there are no intangibles, against the fixed assets. In this case, it is eliminated against the intangible property, goodwill. Had there been no intangible property, it would have been eliminated against the plant account.

REFERENCES:

Treasury Decision 2901.
Article 867, Regulations 45 Revised.

PROBLEM 24

*Computation of Consolidated Invested Capital When
Capital Stock of Subsidiary is Acquired
with Cash at a Premium*

FACTS:

Corporation A, a newspaper, acquired the capital stock of Corporation B, a paper mill, January 1, 1915, for \$200,000 cash.

The goodwill of Corporation A was acquired with stock at par. Its value at the date of acquisition was equivalent to par.

The following data are submitted:

CORPORATION A

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 25,000	Accounts payable ..	\$200,000
Due from Corp. B..	105,000	Capital stock	300,000
Investment in Corp.		Surplus	180,000
B.	200,000		
Plant	200,000		
Goodwill	150,000		
	\$680,000		\$680,000

FEDERAL CORPORATE INCOME TAXES

CORPORATION B

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 35,000	Due Corp. A.....	\$105,000
Accounts receivable.	45,000	Capital stock	100,000
Plant	180,000	Surplus	235,000
Goodwill	180,000		
	<u>\$440,000</u>		<u>\$440,000</u>

CORPORATION B

Balance Sheet as at January 1, 1915, Date of Acquisition by Corporation A

<i>Assets</i>		<i>Liabilities</i>	
Tangible property ..	\$220,000	Accounts payable ..	\$230,000
Intangible property.	180,000	Capital stock	100,000
		Surplus	70,000
	<u>\$400,000</u>		<u>\$400,000</u>

PROBLEM :

Compute the consolidated invested capital.

SOLUTION :

The consolidated balance sheet may be set up as follows:

	Corpora- tion A	Corpora- tion B	Elimina- tions	Consoli- dated Balance Sheet
<i>Assets:</i>				
Cash	\$ 25,000	\$ 35,000		\$ 60,000
Accounts re- ceivable		45,000		45,000
Due from Corp. B	105,000		—\$105,000	
Investment in Corp. B	200,000		— 200,000	
Plant	200,000	180,000		380,000
Goodwill	150,000	180,000	+ 30,000	360,000
	<u>\$680,000</u>	<u>\$440,000</u>	<u>\$275,000</u>	<u>\$845,000</u>

PROBLEMS

Liabilities:

Accounts payable	\$200,000			\$200,000
Due Corp. A..		\$105,000	— \$105,000	
Capital stock..	300,000	100,000	— 100,000	300,000
Surplus	180,000	235,000	— 70,000	345,000
	<u>\$680,000</u>	<u>\$440,000</u>	<u>\$275,000</u>	<u>\$845,000</u>

The invested capital is computed as follows:

Schedule A:

Capital stock, consolidated balance sheet.....	\$300,000
Surplus, consolidated balance sheet	345,000
	<u>\$645,000</u>

Schedule C:

Goodwill of Corporation A.....	\$150,000	
20% of \$300,000.....	60,000	90,000
	<u> </u>	<u> </u>
Consolidated invested capital		<u>\$555,000</u>

The adjustments on account of goodwill and the elimination of intercompany accounts have been explained in Problems 18 and 21, respectively.

The characteristic of this problem is the elimination of the stock of a subsidiary corporation acquired with cash at a premium.

As Corporation A acquired the entire capital stock of Corporation B for \$200,000, the cash paid for same is the amount which must be reflected in the consolidated balance sheet. The capital stock and surplus of Corporation B as at the date of acquisition by Corporation A are eliminated from the liability side, and the investment in Corporation B is eliminated from the asset side. However, if the elimination stopped at this point, the elimination on the asset side would be \$30,000 more than the eliminations on the liability side. This \$30,000 is the premium paid for the stock

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of Corporation B by Corporation A, and in the absence of evidence to prove otherwise is considered an amount paid for intangible property, and is therefore added to the goodwill account of Corporation B.

The principle underlying this method of consolidating the balance sheets of affiliated corporations is simply the elimination of the consideration paid by the parent company against the thing acquired by the parent company for such payment, i. e., the net worth of the subsidiary company as reflected by its books at the date of acquisition. Any excess paid over the book value is equivalent to the purchase of assets not reflected on the subsidiary's books—usually goodwill—and is brought into the consolidated balance sheet as an addition; any discount represents an amount by which the subsidiary company's net worth is overstated on its books when considered in connection with the balance sheet of the parent company, and such overstatement is deducted naturally from any intangible assets in the subsidiary company's balance sheet first and, if such intangibles are entirely eliminated, then from tangibles. Thus the debit and credit eliminations balance.

REFERENCES:

Treasury Decision 2901.

Article 867, Regulations 45 Revised.

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PROBLEM 25

*Computation of Consolidated Invested Capital When
Capital Stock of Subsidiary is Acquired with
Stock Having a Par Value in Excess of
Net Worth of Subsidiary at Date
of Acquisition*

FACTS:

Corporation A, operating several confectionery stores, acquired the capital stock of Corporation B, a candy factory, January 1, 1915, with \$100,000 of the capital stock of Corporation A.

The goodwill of Corporation A was acquired with stock at par, and had a cash value of \$100,000 when acquired.

The following data are submitted:

CORPORATION A

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$110,000	Accounts payable ..	\$200,000
Due from Corp. B..	90,000	Capital stock	400,000
Accounts receivable.	200,000	Surplus	200,000
Investment in Corp.			
B	100,000		
Plant	200,000		
Goodwill	100,000		
	<u>\$800,000</u>		<u>\$800,000</u>

CORPORATION B

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$120,000	Due Corp. A.....	\$ 90,000
Accounts receivable.	20,000	Capital stock	100,000
Plant	80,000	Surplus	210,000
Goodwill	180,000		
	<u>\$400,000</u>		<u>\$400,000</u>

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CORPORATION B

Balance Sheet as at January 1, 1915, Date of Acquisition by Corporation A

<i>Assets</i>		<i>Liabilities</i>	
Tangible property ..	\$120,000	Accounts payable ..	\$240,000
Intangible property.	180,000	Capital stock	100,000
Deficit	40,000		
	\$340,000		\$340,000

The above balance sheet correctly states the cash value of the tangible and intangible property as at the date of acquisition.

PROBLEM:

Compute the consolidated invested capital for 1917.

SOLUTION:

The consolidated balance sheet may be set up as follows:

	Corpora- tion A	Corpora- tion B	Elimina- tions	Consoli- dated Balance Sheet
<i>Assets:</i>				
Cash	\$110,000	\$120,000		\$230,000
Accounts re- ceivable ...	200,000	20,000		220,000
Due from Corp. B ...	90,000		-\$ 90,000	
Investment in Corp. B ...	100,000		- 100,000	
Plant	200,000	80,000		
Goodwill ...	100,000	180,000	+ 40,000	320,000
	\$800,000	\$400,000	\$150,000	\$1,050,000
<i>Liabilities:</i>				
Accounts pay- able	\$200,000			\$200,000
Due Corp. A.		\$ 90,000	-\$ 90,000	
Capital stock	400,000	100,000	- 100,000	400,000
Surplus	200,000	210,000	+ 40,000	450,000
	\$800,000	\$400,000	\$150,000	\$1,050,000

PROBLEMS

The consolidated invested capital is computed as follows:

Schedule A:

Capital stock, consolidated balance sheet.....	\$400,000
Surplus, consolidated balance sheet	450,000
	\$850,000

Schedule C:

Goodwill of Corporation A and Corporation B acquired with capital stock of Corporation A	\$200,000	
20% of \$400,000	80,000	120,000
Consolidated invested capital		\$730,000

The adjustments on account of goodwill and the elimination of intercompany accounts, have been explained in Problems 18 and 21, respectively.

The characteristic of this problem is the elimination of the stock of a subsidiary corporation acquired with stock of the parent company.

The stock of Corporation B was acquired by Corporation A with stock at an amount in excess of the net worth of Corporation B, as shown by the balance sheet of the subsidiary at date of acquisition. The net worth of Corporation B on the date acquired was \$60,000 and the par value of the stock issued for same was \$100,000. The excess \$40,000 is considered as goodwill purchased with stock, and is therefore added to the goodwill of Corporation B in the consolidated balance sheet, making the total amount of goodwill \$320,000, of which \$200,000 was acquired with stock. This amount is arrived at as follows:

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Goodwill Co. A acquired with stock		\$100,000
Goodwill acquired from Co. B..	\$220,000	
Liabilities of Co. B assumed...	\$240,000	
Less: Tangible property acquired	120,000	
	<hr/>	
Goodwill acquired for cash (balance of liabilities assumed) ..	120,000	
Goodwill Co. B acquired with stock of Co. A		<hr/> 100,000
		<hr/>
Total goodwill acquired with stock		\$200,000

The regulations provide, and the Bureau practice has been, that where stock or shares have been issued for a mixed aggregate of tangible and intangible property and certain liabilities have been assumed in connection with the transaction, it is presumed that such liabilities are to be charged against the tangible property and the intangible property in the order named, unless it is shown by evidence satisfactory to the Commissioner that this is not in accordance with the facts.

In the foregoing case Company B, at the time it was acquired by Company A, had liabilities amounting to \$240,000. Through the acquisition of Company B's stock by Company A, Company A in effect assumed the liabilities of Company B, the transaction thereby resolving itself into one tantamount to the issue of shares and obligations for a mixed aggregate of tangible and intangible property. These obligations, or liabilities, are to be charged first against the tangible property of Company B, the cash value of which was \$120,000, and the remaining \$120,000 liabilities are to be charged against the intangibles. Intangibles to the latter amount are considered as hav-

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ing been acquired with cash, and are taken into invested capital at cost. The goodwill limitations apply, therefore, in this case only to so much of the goodwill acquired from Company B as exceeds the amount (\$120,000) acquired for cash, i. e., \$220,000 less \$120,000, or \$100,000. This amount plus the \$100,000 goodwill on the balance sheet of Company A, which was also acquired with stock, results in a total of \$200,000 goodwill acquired with stock, as shown above.

REFERENCE:

Articles 835 and 868, Regulations 45 Revised.

PROBLEM 26

*Computation of Consolidated Invested Capital When
Subsidiary Company's Assets at Date of Acquisition
Have a Cash Value in Excess of the
the Book Value, and Stock of Sub-
sidiary was Acquired with Stock
of Parent Company*

FACTS:

Company A, an ice dispensing company, acquired the entire capital stock of Company B, operating a refrigerating plant, with stock of Company A having a par value of \$100,000. The balance sheet of Company B at date of acquisition did not reflect the true value of tangible property which had an actual cash value of \$60,000. The goodwill of Company A was acquired with stock at par and had a cash value of \$45,000 at acquisition.

Goodwill of Company B, amounting to \$20,000, was acquired with cash January 16, 1916.

The balance sheet of Company A, as at December 31, 1916, is as follows:

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<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 10,000	Accounts payable ..	\$100,000
Securities	345,000	Reserve for depreci-	
Accounts receivable.	25,000	ation	20,000
Plant and property.	100,000	Capital stock	200,000
Goodwill	50,000	Surplus	210,000
	<u>\$530,000</u>		<u>\$530,000</u>

The balance sheet of Company B as at December 31, 1916, shows:

<i>Assets</i>		<i>Liabilities</i>	
Securities	\$ 10,000	Accounts payable ..	\$ 75,000
Accounts receivable.	60,000	Capital stock	50,000
Plant and property.	140,000	Surplus	155,000
Goodwill	70,000		
	<u>\$280,000</u>		<u>\$280,000</u>

An analysis of the Securities accounts shows:

<i>Company A</i>		<i>Company B</i>	
U. S. 2% bonds	\$ 75,000	N. Y. City bonds...	\$ 10,000
Central Leather Com.	100,000		
N. Y. City bonds...	70,000		
Company B stock...	100,000		
	<u>\$345,000</u>		<u>\$ 10,000</u>

Balance sheet of Company B at date of acquisition, January 1, 1916, as per books, shows:

<i>Assets</i>		<i>Liabilities</i>	
Tangible property ..	\$ 50,000	Capital stock	\$ 50,000
Intangible property.	50,000	Surplus	10,000
		Liabilities	40,000
	<u>\$100,000</u>		<u>\$100,000</u>

PROBLEM:

Compute the 1917 invested capital for excess profits tax purposes.

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SOLUTION:

As Company A owns 100 per cent of the capital stock of Company B, a consolidated excess profits tax return is required for the taxable year 1917.

The consolidated balance sheet, including the two companies as at January 1, 1917, shows:

	Company A	Company B	Elimina- tions	Consoli- dated
<i>Assets:</i>				
Cash	\$ 10,000			\$ 10,000
Securities	345,000	\$ 10,000	—\$100,000	255,000
Accounts re- ceivable	25,000	60,000		85,000
Plant and prop- erty	100,000	140,000	+ 10,000	250,000
Goodwill	50,000	70,000	+ 30,000	150,000
	<u>\$530,000</u>	<u>\$280,000</u>	<u>\$ 60,000</u>	<u>\$750,000</u>
<i>Liabilities:</i>				
Accounts paya- ble	\$100,000	\$ 75,000		\$175,000
Reserve for de- preciation ..	20,000			20,000
Capital stock..	200,000	50,000	—\$ 50,000	200,000
Surplus	210,000	155,000	— 10,000	355,000
	<u>\$530,000</u>	<u>\$280,000</u>	<u>\$ 60,000</u>	<u>\$750,000</u>

As \$100,000 par value stock of the parent company was issued for a net worth of \$60,000, of the difference of \$40,000, \$10,000 is considered as representing tangible property and \$30,000 is considered as capital stock issued for goodwill; therefore these accounts are increased accordingly.

Tangible property paid in for stock or shares on or after January 1, 1914, will be taken at the actual cash value of such property at the time of payment irrespective of the par value of the stock or shares issued therefor. Therefore, if the cash value at date of ac-

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quisition is in excess of, or lower than, the amounts reflected on the books, the invested capital should be adjusted accordingly.

COMPUTATION OF INVESTED CAPITAL

Schedule A:

Capital stock	\$200,000	
Surplus	355,000	
	<u> </u>	\$555,000

Schedule C:

Deductions:

Item 1. Goodwill disallowed	\$ 90,000	
" 8. Inadmissible	5,000	
	<u> </u>	95,000

Invested capital	<u><u>\$460,000</u></u>
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COMMENTS:

When stock of a subsidiary is acquired with stock of the parent company, the amount to be included in the consolidated invested capital with respect to the company acquired shall be computed in the same manner as if the net tangible assets and the intangible assets had been acquired instead of the stock.

Inadmissibles are computed as follows:

Central Leather Common	\$100,000
New York City bonds	70,000
Inadmissibles owned by Company B, New York City bonds	<u>10,000</u>
Total inadmissibles of the consolidated group.....	\$180,000
Less the total indebtedness of the consolidated group	<u>175,000</u>
Total inadmissibles to be eliminated from invested capital	<u><u>\$ 5,000</u></u>

The goodwill disallowance was arrived at as follows:

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Total goodwill as reflected on consolidated balance sheet	\$150,000
Less amount acquired with cash	20,000
Goodwill acquired with stock	\$130,000
Less 20% capital stock outstanding March 3, 1917— \$200,000	40,000
Goodwill disallowed	<u>\$ 90,000</u>

The goodwill of Company A had a cash value of \$45,000, which is in excess of the 20 per cent limitation. The cash value of Company B's goodwill is not known, but Regulations 41 state that goodwill acquired with stock can not be included in invested capital at an amount greater than 20 per cent of the par value outstanding March 3, 1917. The 20 per cent limitation is lower in the above case than the cash value of Company A's goodwill at acquisition, and therefore only \$40,000 goodwill has been allowed.

REFERENCE:

Paragraph 2, Article 55, Regulations 41.

PROBLEM 27

Computation of Invested Capital When One Company Has a Deficit in a Class B Consolidation

FACTS:

Corporations A and B are owned and controlled by the same interests, and are required to file a consolidated return.

The following data are submitted:

CORPORATION A

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 50,000	Accounts payable ..	\$ 10,000
Buildings	50,000	Capital stock	50,000
		Surplus	40,000
	<u>\$100,000</u>		<u>\$100,000</u>

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CORPORATION B

Balance Sheet as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 75,000	Accounts payable..	\$100,000
Buildings	75,000	Capital stock	100,000
		Deficit	(50,000)
	<u>\$150,000</u>		<u>\$150,000</u>

PROBLEMS:

(a) Assuming that the deficit of Corporation B was created by operations of the business, compute the invested capital as at the beginning of 1917.

(b) Assuming that the deficit was caused by a capital distribution, compute the invested capital as at the beginning of 1917.

SOLUTIONS:

	Corpora- tion A	Corpora- tion B	Consoli- dated Balance Sheet
<i>Assets:</i>			
Cash	\$ 50,000	\$ 75,000	\$125,000
Buildings	50,000	75,000	125,000
	<u>\$100,000</u>	<u>\$150,000</u>	<u>\$250,000</u>
<i>Liabilities:</i>			
Accounts payable ...	\$ 10,000	\$100,000	\$110,000
Capital stock	50,000	100,000	150,000
Surplus	40,000		
Deficit		(50,000)	(10,000)
	<u>\$100,000</u>	<u>\$150,000</u>	<u>\$250,000</u>

The consolidated invested capital for 1917 in accordance with assumption (a)—on the basis of an operating deficit—would be \$150,000.

The consolidated invested capital for 1917 in accordance with assumption (b)—on the basis of a deficit created by capital distribution—would be \$140,000.

In consolidating the two companies, the surplus of

PROBLEMS

Corporation A is applied against the deficit of Corporation B, leaving a net deficit amounting to \$10,000. This rule applies within certain limitations in all consolidations, i. e., the deficit of one company must be applied against the surplus of the other company included in the consolidated return.

When the deficit is created by operations, the invested capital will be the consolidated capital stock, and the deficit will have no effect on invested capital.

When the deficit is created by capital distribution, the invested capital will be the consolidated capital stock, less the consolidated deficit.

REFERENCE:

Article 860, Regulations 45 Revised.

PROBLEM 28

Computation of Invested Capital in a Class A Consolidation When One Company Has a Deficit

FACTS:

Company A, a steel manufacturing company, was organized in 1910 and issued capital stock of \$100,000 par value for \$75,000 cash.

In 1915 Company A acquired the capital stock of Company B, a coal mine, for \$10,000 cash, the appraised value of the assets of Company B at date of acquisition.

Balance Sheet of Company A as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 20,000	Accounts payable ..	\$ 25,000
Investment	10,000	Reserve for depreciation	26,250
Plant and equipment	75,000	Capital stock	110,000
Goodwill	25,000		
Deficit	31,250		
	<u>\$161,250</u>		<u>\$161,250</u>

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Balance Sheet of Company B as at January 1, 1917

<i>Assets</i>		<i>Liabilities</i>	
Cash	\$ 5,000	Reserve for depletion. \$	2,000.
Accounts receivable..	2,600	Capital stock	10,000
Mine and equipment.	10,000	Surplus	5,600
	<u>\$17,600</u>		<u>\$17,600</u>

Balance Sheet of Company B as at January 1, 1915, Date of Acquisition by Company A

<i>Assets</i>		<i>Liabilities</i>	
Mine and equipment.	\$10,000	Capital stock	\$10,000

An analysis of the surplus account of Company A for 1910 to 1917 shows the following:

PROBLEMS

	Debits	Credits	Balance	Balance when Stock Dividends are included as Surplus	Dividends Paid Out of Capital
1910					
Earnings		\$20,000			
Dividends paid	\$10,000			\$10,000	
1911					
Earnings		25,000			
Stock dividend distributed	10,000				
1912					
Loss on operations	5,000		25,000	35,000	
Dividends paid	10,000				
1913					
Loss on operations	11,000		10,000	20,000	
Dividends paid	10,000				
1914					
Earnings		21,000			\$ 1,000
Dividends paid	10,000				
1915					
Earnings		6,000	0	10,000	
Dividends paid	10,000				
1916					
Loss on operations	17,250				
Dividends paid	10,000				
Balance January 1, 1917					
(deficit)			—\$31,250	—\$21,250	10,000
Total dividends paid out of capital					\$11,000

NOTE:—All dividends were payable on the last day of the year.

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As stock dividends paid out are not considered a distribution of earnings they should be taken into consideration as part of surplus in determining whether cash dividends have been paid out of earnings or out of paid-in capital or surplus.

Analysis of the surplus account of Company B from 1915 to 1917 shows:

	Dr.	Cr.	Balance
1915 earnings		\$2,000	\$2,000
1916 earnings		3,600	5,600

PROBLEM:

Determine the consolidated invested capital.

SOLUTION:

*Consolidated Balance Sheet as at January 1, 1917,
Companies A and B*

<i>Assets:</i>	Co. A	Co. B	Elimina- tions	Consoli- dated
Cash	\$ 20,000	\$ 5,000		\$ 25,000
Accounts receivable		2,600		2,600
Investments	10,000		\$10,000	
Plant and equip- ment	75,000	10,000		85,000
Goodwill	25,000			25,000
Deficit	31,250		5,600	25,650
	<u>\$161,250</u>	<u>\$17,600</u>	<u>\$15,600</u>	<u>\$163,250</u>
 <i>Liabilities:</i>				
Accounts payable..	\$ 25,000			\$ 25,000
Reserve for depreci- ation	26,250			26,250
Reserve for deple- tion		\$ 2,000		2,000
Capital stock	110,000	10,000	\$10,000	110,000
Surplus		5,600	5,600	
	<u>\$161,250</u>	<u>\$17,600</u>	<u>\$15,600</u>	<u>\$163,250</u>

PROBLEMS

ELIMINATIONS:

As Company A owns 100 per cent of the capital stock of Company B, forming a "parent and child" affiliation, the two companies are consolidated and the assets of Company B are substituted for the investment of Company A in the capital stock of Company B; therefore the capital stock of Company B is eliminated both from the investment account of Company A and from the capital stock account.

The surplus of Company B, being less than the deficit of Company A, is applied against the deficit.

Article 860, Regulations 45 Revised, provides that "capital or surplus actually paid in is *not* required to be reduced because of an impairment of capital in the nature of an operating deficit, except where there has been directly or indirectly a liquidation or return of their investment to the stockholders, in which case full effect must be given to any liquidation of original capital."

Therefore, the question to be determined is whether the above deficit of \$25,650 represents an operating deficit or a liquidation of original capital.

An analysis of the records of Company A and Company B shows that the original paid-in capital was		\$75,000
In 1913 dividends paid out of capital amounted to	\$ 1,000	
" 1916 dividends paid out of capital amounted to	10,000	
	<hr/>	
Total impairment of capital.....		11,000
		<hr/>
Amount allowed as invested capital under Article 860		\$64,000

The goodwill account of \$25,000 represented the difference between the par value of the stock of \$100,-

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000 and the consideration received—\$75,000 cash—and therefore is not goodwill but stock discount and should not be included in invested capital.

It should be noted that a stock dividend is not considered a distribution of earnings, nor is it treated as paid-in capital.

PROBLEM 29

*Consolidated Return—Control of a Subsidiary Secured During the Taxable Year 1917—
Basis upon which Returns
Should be Filed*

FACTS:

On September 1, 1917, Company A, wholesale druggists, purchased 100 per cent of the stock of Company B, a retail drug store. The capital stock of Company B is \$50,000, for which Company A paid \$75,000 in cash. Both Company A and Company B had been rendering income tax returns on the basis of the calendar year.

PROBLEM:

State what returns are required for 1917.

SOLUTION:

Company A and Company B are each required to file income tax returns for the calendar year 1917. The Bureau would ordinarily require that Company B file an excess profits tax return for the period from January 1, 1917, to August 31, 1917, while Company A file an excess profits tax return for the calendar year 1917, including in such return the income of Company B for the period from September 1, 1917, to December 31, 1917.

PROBLEMS

The invested capital of Company A is not increased by the acquisition of the stock of Company B, as Company A paid cash for the stock, bringing about a change in form of the assets of Company A, that is, substituting the assets of Company B for the cash paid, but effecting no increase in invested capital as a result of the exchange.

PROBLEM 30

*Method of Arriving at Consolidated Net Income When
Subsidiaries Have Taxable Years Different
from that of the Parent Company*

FACTS:

Company A, a sugar refinery, has two subsidiaries, Company X and Company Y, both sugar plantations. Each company kept its books on a different fiscal year basis and filed its return accordingly.

Company A's taxable year ended December 31, 1918, and its net income for the year was \$8,000.

Company X's fiscal year ended January 31, 1918, and its net income for this period was \$3,000. For the fiscal year ended January 31, 1919, the net income was \$2,000.

Company Y's fiscal year ended March 31, 1918, and its net income for this period was \$6,000. For the fiscal year ended March 31, 1919, the net income was \$7,000.

PROBLEM:

From the above facts determine the consolidated net income for 1918 for income and profits tax purposes.

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SOLUTION:

Company A:

Income for year ended December 31, 1918	\$ 8,000.00
--	-------------

Company X:

One-twelfth of \$3,000 income for fiscal year ended January 31, 1918	\$ 250.00
Eleven-twelfths of \$2,000 income for fiscal year ended January 31, 1919	1,833.33
	<hr/>
Total taxable income for twelve months in 1918	2,083.33

Company Y:

Three-twelfths of \$6,000 income for fiscal year ended March 31, 1918	\$1,500.00
Nine-twelfths of \$7,000 income for fiscal year ended March 31, 1919	5,250.00
	<hr/>
Total taxable income for twelve months in 1918	6,750.00

Total net income as adjusted to taxable year of parent company	\$16,833.33
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PROBLEM 31

Method of Arriving at Average Consolidated Net Income and Invested Capital for Pre-war Period

FACTS:

The pre-war earnings and invested capital of the affiliated companies A, B and C ("brother and brother" relation), which were affiliated throughout the entire pre-war period as well as the taxable year, were as follows:

	EARNINGS		
	1911	1912	1913
Company A	-\$3,000 (loss)	\$ 7,000	\$20,000
Company B	5,000	— 8,000 (loss)	6,000
Company C	2,000	— 9,000 (loss)	4,000
	<hr/>	<hr/>	<hr/>
Totals	\$4,000	-\$10,000	\$30,000

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CONSOLIDATED INVESTED CAPITAL

1911	1912	1913	Total
\$225,000	\$235,000	\$240,000	\$700,000

PROBLEM:

Compute the average pre-war net income and invested capital.

SOLUTION:

The total net income during the pre-war period for tax purposes is \$34,000.

The average net income is \$34,000 divided by 3, or \$11,333.33.

Average invested capital for the pre-war period is \$700,000 divided by 3, or \$233,333.33.

The percentage of the average net income to the average invested capital amounts to approximately 5 per cent; the deduction for 1917 therefore is 7 per cent.

The following facts should be borne in mind in connection with the above computation:

In determining the consolidated net income for each of the pre-war years, where corporations affiliated during the taxable year were also affiliated in the pre-war period, a loss of one company is deductible from profits of the others. But a consolidated loss in one pre-war year is not deducted from net income of the other pre-war years.

REFERENCES:

Articles 802 and 869, Regulations 45 Revised.

FEDERAL CORPORATE INCOME TAXES

PROBLEM 32

Illustrating Method of Computing Average Pre-war Income When Not All of the Affiliated Companies Were a Part of the Affiliated Group During the Pre-War Period

FACTS:

Corporations A, B and C were affiliated during the pre-war period. Corporations X and Y were independent corporations during that period. The corporations were all affiliated during 1918, and were required to file a consolidated income and profits tax return. The net income of each corporation during the pre-war period was as follows:

	1911	1912	1913
Corp. A...	\$ 75,000	—\$50,000 (loss)	—\$25,000 (loss)
Corp. B...	50,000	40,000	50,000
Corp. C...	25,000	— 70,000 (loss)	20,000
Corp. X...	125,000	25,000	— 25,000 (loss)
Corp. Y...	— 50,000 (loss)	30,000	— 25,000 (loss)

PROBLEM:

From the above facts, compute the average net income for the pre-war period in accordance with Article 802, Regulations 45 Revised.

SOLUTION:

Name of Corporation	1911	1912	1913	Total	Average
Affiliated:					
Corp. A..	\$ 75,000	—\$50,000	—\$25,000		
Corp. B..	50,000	40,000	50,000		
Corp. C..	25,000	— 70,000	20,000		
Totals.	\$150,000	—\$80,000	\$45,000	\$195,000	\$ 65,000
Not affiliated:					
Corp. X..	\$125,000	\$25,000	—\$25,000	\$150,000	\$ 50,000
Corp. Y..	— 50,000	30,000	— 25,000	30,000	10,000
Average pre-war earnings of consolidated group.....					\$125,000

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It should be noted from the above that losses of an affiliated company must be deducted from the profits of other affiliated companies in the same year. However, a loss for one pre-war year should not be deducted from the profits of the other pre-war years.

The average net income of the above companies for the pre-war period is the average consolidated net income of the several corporations that were affiliated during the pre-war years, plus the aggregate of the average net incomes of the corporations not affiliated during the pre-war period.

PROBLEM 33

Special Case—Advertising Expense Capitalized as Goodwill

FACTS:

A corporation organized in 1885 expended in cash from date of organization to December 31, 1890, \$200,000 in advertising trade brands, etc. This amount was deducted from income as an expense, but carried in a separate account from operating expenses. The officials of the company claim it was their intention from the beginning to capitalize this expense, but no record was made of that intention until at the close of business December 31, 1890, when a stock dividend of \$200,000 was declared.

QUESTION:

Under these circumstances, is it permissible to include this item in invested capital?

ANSWER:

Yes.

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PROBLEM 34

Illustrating the Method Usually Employed by the Bureau of Computing the 5 Per Cent Negligence Penalty Under the Revenue Act of 1918

PENALTIES:

A penalty of 5 per cent of the total additional tax must be assessed under the 1918 law whenever a corporation has had errors in its return which are attributable to negligence. At the present time penalties for negligence are being assessed, among other reasons, for the deduction of donations as an expense and also for the deduction of income and excess profits taxes paid.

It should be noted that the penalty assessed is 5 per cent of the *total additional* tax. For example, if a corporation originally files a return showing \$100,000 total tax for the calendar year 1918 and the audit results in a total tax of \$125,000, the entire \$25,000 of additional tax resulting from the audit is subject to the 5 per cent penalty if the taxpayer has been negligent in regard to any item in his return.

The taxpayer in meritorious cases, however, may take advantage of the special provision of the law permitting the compromise of penalties, if he cares to do so, and the Department will usually accept an offer in compromise of an amount not less than 5 per cent of the additional tax directly attributable to negligence, plus interest at the rate of 1 per cent per month upon this amount from the time the payments of tax were originally due until the date paid.

Let us take a hypothetical case:

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Net income returned	\$20,000.00
Depreciation disallowed	4,000.00
	<hr/> \$24,000.00
Deduction of 1917 income and excess profits taxes disallowed	2,500.00
Donations disallowed	500.00
	<hr/>
Corrected net income for the taxable year 1918....	<u>\$27,000.00</u>
Corrected income and profits taxes on the basis of \$27,000 net income	\$12,416.00
Original tax paid	6,648.00
	<hr/>
Additional tax	\$ 5,768.00
Penalty of 5% to be assessed because a part of the additional tax is attributable to negligence.....	\$ 288.40

Compromise of Penalty

Corrected income and profits taxes as above on basis of \$27,000 net income	\$12,416.00
Corrected income and profits taxes on the basis of \$24,000 income	9,944.00
	<hr/>
Additional tax directly attributable to negligence..	\$ 2,472.00
Compromise penalty 5% of \$2,472, or \$123.60, plus interest at the rate of 1% per month as described above.	

REFERENCES:

Articles 1003 and 1005, Regulations 45 Revised.

PROBLEM 35

*Propriety of Consolidation—Class B, “Brother and
Brother”*

FACTS:

Company X is engaged in the lumber business.

Company Y is a railroad, which is used for hauling logs to the sawmill and manufactured lumber to the river front ready to be loaded on vessels. The above companies were owned by the same stockholders in the following proportions:

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	Company X	Company Y
John Doe	68%	70%
William Fox	12%	10%
Joseph Smith	20%	20%
	<hr/> 100%	<hr/> 100%

The above stockholders held the same percentages of stock throughout the year 1917.

QUESTION:

Should a consolidated excess profits tax return be filed for the taxable year 1917?

ANSWER:

Yes.

It might be said that the lumber company and the railroad company are not engaged in the same line of business. However, they are engaged in a closely related business, one depending absolutely on the other; therefore, they are considered as one economic unit.

As the two companies are owned by the same interests in substantially the same proportion, they come squarely within the purview of Articles 77 and 78 of Regulations 41.

This is a Class B consolidation or "brother and brother" relationship, which has been explained in full in the text.

PROBLEM 36

Propriety of Consolidation—Effective Stock

FACTS:

Company X retails sporting goods, and has both common and preferred stock outstanding; the preferred stock is non-voting, pays a 6 per cent cumula-

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tive dividend and is preferred as to the distribution of assets.

Company Y manufactures ice skates, and has but one class of stock outstanding.

The shareholders of Companies X and Y, both of which are domestic corporations, held stock in the following proportions throughout the entire year 1920:

	Company X		Company Y
	Common Stock	Preferred Stock	Common Stock
John Smith	50%	73%	48%
John Doe	50%	27%	52%
	<hr/> 100%	<hr/> 100%	<hr/> 100%

QUESTION:

Should a consolidated income and profits tax return be filed for the taxable year 1920?

ANSWER:

Yes.

The common stock held by J. Smith and J. Doe in Companies X and Y is held by them substantially in the same proportion in the two companies, but the preferred stock is not held in the same proportion.

The common stock in this particular case is the voting stock and therefore the "effective" stock. As the preferred stock cannot vote it is not "effective," and hence is not considered in determining the propriety of consolidation.

(1) Effective stock must entitle the owner to a voice in the management of the business.

(2) Effective stock must have a direct interest in the allocation of income and expenses as between companies.

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PROBLEM 37

Propriety of Consolidation—Class A, “Parent and Child”

FACTS:

Company X manufactures automobiles, and Companies A, B and C are automobile selling agencies.

The stockholdings for the entire year 1917 were as follows:

Stockholders	Company X	Company A	Company B	Company C
H. Adams	2%	25%		
M. Jones	3%	25%		
I. Williams	3%			
J. Kelly	60%	30%		
L. Oliver	16%	20%		
P. Murphy	16%			
Company X			100%	100%
	<hr/> 100%	<hr/> 100%	<hr/> 100%	<hr/> 100%

QUESTION:

Should a consolidated excess profits tax return be filed for the taxable year 1917?

ANSWER:

Companies X, B and C should file a consolidated excess profits tax return. Company A should file a separate excess profits tax return, as it is not affiliated with the other three companies. There can be no question in regard to the affiliation of Companies X, B and C, as Company X owns the entire capital stock of Companies B and C, and as the two subsidiary companies are selling agencies of the parent, they are in the same or closely related business. This is what is known in the Bureau as a Class A consolidation or a “parent and child” relationship.

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It will be noted that Company X does not own any of the stock of Company A but that the stock of Company A is owned by some of the stockholders of Company X. However, the stock is not held by the same interests in substantially the same proportion; therefore Company A would be excluded from the consolidation.

PROBLEM 38

Propriety of Consolidation—Classes A and B Combined

FACTS:

Company X, a coal mining company, leases coal lands to Company Y for a royalty based on tonnage output.

The stockholdings in the respective companies are as follows for the taxable year 1917.

Stockholders	Company X	Company Y
Company X		91%
A. York	25%	2%
B. Morris	25%	3%
C. Klein	25%	2%
D. Cook	25%	2%
	<hr/> 100%	<hr/> 100%

QUESTION:

Is a consolidated excess profits tax return required for the taxable year 1917?

ANSWER:

Yes.

The answer is based on the assumption that the stockholdings in the two companies remained the same for the entire taxable year.

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A case of this character is considered by the Income Tax Unit as a "parent and child" relationship.

If the stock held by Company X in Company Y is divided among the stockholders of Company X on the basis of the stock held in that company, it will be readily seen that Mr. York's indirect stockholdings in Company Y is $22\frac{3}{4}$ per cent plus 2 per cent held direct, making a total of $24\frac{3}{4}$ per cent against 25 per cent held in Company X. By using this method Mr. Morris's holdings will be $25\frac{3}{4}$ per cent in Company Y, while Mr. Klein and Mr. Cook will have $24\frac{3}{4}$ per cent each in Company Y.

It will be noted that the stock is held substantially in the same proportion by the same interests if the direct stockholdings are added to the indirect stockholdings through Company X.

PROBLEM 39

Propriety of Consolidation—Class B—Variation in Stockholdings

FACTS:

Companies Nos. 1, 2 and 3 are piano manufacturers and their stock is held as follows:

Stockholders	Company 1	Company 2	Company 3
J. Smith	49%	50%	48%
H. Jones	15%	15%	18%
C. White	36%	35%	32%
F. Smythe			2%
	<hr/> 100%	<hr/> 100%	<hr/> 100%

QUESTION:

Is a consolidated excess profits tax return required for the taxable year 1917?

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ANSWER:

Yes, provided the same conditions obtained during the entire taxable year.

The stock in this instance is held by the same interests in substantially the same proportion in each of the affiliated corporations. This case is what is known in the Bureau as a "brother and brother" relationship.

What is substantially the same proportion, is the question frequently asked. In Class B corporations, such as the above, where there are only three or four stockholders, the Income Tax Unit has allowed as high as 5 per cent variation in stockholdings. The percentage of permissible variation is much smaller as a rule in corporations where there are a large number of stockholders. Of course, no general rule can be prescribed as each case has to be considered on its own merits, keeping in mind the purpose of consolidating tax returns, namely, to tax as a single economic unit corporations owned or controlled by the same interests.

Under Article 77, Regulations 41 (1917 law), corporations were required to file a consolidated excess profits tax return if their stock was held by the same interests in substantially the same proportion in each of the affiliated corporations, provided such corporations were engaged in the same or a closely related business; it will be noted that in 1918 the law is silent regarding corporations being in the same line of business. Therefore, if two or more domestic corporations come within the provisions of Section 240 of the Revenue Act of 1918, a consolidated income and profits tax return will be required whether or not the affli-

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ated corporations are in the same or closely related businesses.

PROBLEM 40

Propriety of Consolidation—Unrelated Businesses

FACTS:

Company X operates a brick yard.

Company Y manufactures musical instruments.

Company W conducts a retail book store.

Company Z operates a marble quarry.

The stockholdings in the above domestic corporations were as follows, without change during the taxable years 1917, 1918, 1919 and 1920.

Stockholders	Company X	Company Y	Company W	Company Z
J. Archibald ..	50%	50%		50%
W. Brown	50%	50%		50%
Company X ..			50%	
Company Y ..			50%	
	100%	100%	100%	100%

QUESTION:

Should a consolidated excess profits tax return be filed for the taxable year 1917 and consolidated income and profits tax returns for the taxable years 1918, 1919 and 1920?

ANSWER:

For the taxable year 1917, no consolidated return should be filed. Each company should file separate returns, as no two of the above companies are in the same or closely related businesses. For the taxable years 1918, 1919 and 1920 consolidated income and profits tax returns should be filed, as Archibald and Brown held stock in Companies X, Y and Z during

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this period in exactly the same proportion, and because Companies X and Y owned the entire capital stock of Company W. As X, Y, Z and W are all domestic corporations they come within the purview of Section 240 of the Revenue Act of 1918.

This case is a combination of the so-called "brother and brother" and "parent and child" relationships.

PROBLEM 41

Propriety of Consolidation—Related Businesses

FACTS:

Company X is engaged in manufacturing automobiles, and takes the entire output of Company W which is a foundry. Company Y is a department store and Company Z is a tannery. All of these are domestic corporations.

The stockholdings remained constant during 1917 and 1918 and were as follows:

Stockholders	Company X	Company Y	Company Z	Company W
Company X ...		60%		100%
F. Johnson	5%	36%	50%	
M. Smith	50%	3%	40%	
Minorities	45%	1%	10%	
	100%	100%	100%	100%

QUESTION:

Should a consolidated excess profits tax return be filed for the taxable year 1917 and a consolidated income and profits tax return for the taxable year 1918?

ANSWER:

Companies X and W should file a consolidated excess profits tax return for 1917 and a consolidated income and profits tax return for 1918.

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Companies Y and Z are not affiliated in accordance with the requirements of Articles 77 and 78 of Regulations 41 and Treasury Decision 2662 nor Section 240 of the Revenue Act of 1918, and therefore should file separate returns for both 1917 and 1918.

Inasmuch as the automobile company owns all of the capital stock of the foundry company and takes its entire output, the companies are considered as one economic unit and hence come within the provisions of the articles, Treasury Decision, and law quoted above. Company Y is excluded from the consolidation for the reason that Company X does not own an amount of its stock large enough to warrant bringing it within the purview of the law and regulations as interpreted by the Income Tax Unit. Further, there are no intercompany transactions to indicate that the companies are operating as a unit. The minority interest owns no stock directly in Company Y. However, the minority stockholders do own 27 per cent indirectly by being stockholders in Company X, but even then the stock is not held by the same interests in substantially the same proportion.

Company X owns no stock in Company Z and as the stock is not held by the same interests in substantially the same proportion and as there are no other relations between the companies, Company Z would be excluded from the consolidation.

PROBLEM 42

Propriety of Consolidation—Classes A and B Combined

FACTS:

Company X operates an iron mine furnishing ore to Company Y, which manufactures sheet steel. Com-

PROBLEMS

pany Z is a selling agency for Company Y. There were no changes in stockholdings during the taxable years 1917 and 1918, which were as follows:

Stockholders	Company X	Company Y	Company Z
A. J. Brown	20%	20%	
H. Black	20%	20%	
D. Ewing	20%	20%	
F. Bradley	20%	20%	
S. Seligman	20%	20%	
Company Y			100%
	100%	100%	100%

QUESTION:

Should a consolidated excess profits tax return be filed for the taxable year 1917 and a consolidated income and profits tax return for the taxable year 1918?

ANSWER:

Yes.

The stock in Companies X and Y is held exactly in the same proportion by the same interests, and Company Y in turn owns the entire capital stock of Company Z. Moreover, the companies are in the same or a closely related business.

Company Z is a "child" of Company Y and Company X is a "brother" of Company Y, therefore Companies Y and Z should be consolidated as "parent and child" and Companies X and Y as "brother and brother" companies.

PROBLEM 43

Propriety of Consolidation, Class B

FACTS:

Companies X, Y, Z and W manufacture cigarettes. The stockholdings were as follows:

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Stockholders	Company X	Company Y	Company Z	Company W
A. Andrews ...	48%	75%	74%	99%
F. Dunn	50%	22%	26%	
J. Schwarz	2%	3%		
P. Helfrig				1%
	<hr/> 100%	<hr/> 100%	<hr/> 100%	<hr/> 100%

QUESTION:

Should a consolidated income and profits tax return be filed by the above companies for the taxable year 1918?

ANSWER:

Companies Y and Z would be required to file a consolidated income and profits tax return for the taxable year 1918, if the ratio of stockholdings remained the same, as shown above, during the year.

Companies X and W could not be required to be included in the consolidated return for the reason that the stock in these two companies is not held by the same interests in substantially the same proportion.

It will be noted that Mr. Andrews and Mr. Dunn hold stock in Companies Y and Z in substantially the same proportion, practically $\frac{3}{4}$ and $\frac{1}{4}$, respectively, while in Company X Mr. Andrews and Mr. Dunn each own about one-half of the stock. Company W is owned entirely by Mr. Andrews with the exception of 1 per cent and Mr. Dunn has no interest in it whatsoever.

Companies Y and Z are classed as a "brother and brother" or Class B consolidation.

PROBLEMS

PROBLEM 44

Propriety of Consolidation—Stock Acquired by Gift

FACTS:

Company X is engaged in manufacturing fertilizer.

Company Y operates an acid plant, the entire output of which is taken by Company X at 10 per cent below market.

Company Z is a distributing agency, and was organized June 1, 1917.

Company W is engaged in manufacturing farm machinery.

Company H is engaged in manufacturing washing machines.

The stockholdings remained constant through the year 1917 and were as follows:

Stockholders	Co. X	Co. Y	Co. Z	Co. W	Co. H
W. Barton (father) ..	86%	100%		50%	80%
L. Barton (son)	5%			10%	3%
V. Barton (daughter) ..	2½%			10%	2%
Minority	6½%			30%	15%
Company X			100%		
	<hr/> 100%	<hr/> 100%	<hr/> 100%	<hr/> 100%	<hr/> 100%

Stockholders L. Barton and V. Barton acquired their stock from W. Barton, their father, by gift.

QUESTION:

Should a consolidated excess profits tax return be filed by the above named companies for the taxable year 1917?

ANSWER:

A consolidated excess profits tax return should be filed by Companies X and Y for the entire year, in-

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cluding therein Company Z from June 1, 1917, the date of organization, to the end of the taxable year of the parent corporation. Companies W and H should file separate income and profits tax returns for the taxable year 1917.

As L. Barton and V. Barton acquired their stock by gift, their interest is considered the same as if W. Barton owned 93½ per cent of Company X, and as W. Barton owns 100 per cent of Company Y his interest is substantially the same in each of the two companies. The minority interest of 6½ per cent is disregarded in this instance, inasmuch as the entire output of Company Y is taken by Company X at 10 per cent below market, which indicates that the two companies are operating as an economic unit.

Company Z is a distributing agency for Company X, and as it is entirely owned by Company X there is no question as to its being included in the consolidation.

The stock in Companies W and H is not held by the same interests in substantially the same proportion and there is a large minority interest in the two companies. Moreover, the companies are not in the same line of business; therefore they do not come within the provisions of Articles 77 and 78 of Regulations 41, and Treasury Decision 2662, outlining the basis for consolidating corporate returns under the 1917 Revenue Act.

NOTE.—Companies X and Z are consolidated as a “parent and child” and Companies X and Y as a “brother and brother” combination.

PROBLEMS

PROBLEM 45

Propriety of Consolidation—Leased Companies

FACTS:

Companies A, B, C, D and E are electric railway companies operating in New England. The above companies are owned by the following stockholders:

Stockholders	Co. A	Co. B	Co. C	Co. D	Co. E
X, Y, Z Co.	95%	95%	96%	97%	98%
Minority	5%	5%	4%	3%	2%
	<hr/> 100%	<hr/> 100%	<hr/> 100%	<hr/> 100%	<hr/> 100%

Companies A, B, C, D and E are all leased by X, Y, Z Company to the Pocahontas Railway Company for the following periods:

Company A	for 999 years
" B	for 800 "
" C	for 500 "
" D	for 600 "
" E	for 900 "

The leases provided, among other things, that the Pocahontas Railway Company should pay to the lessor each year an amount equal to 7 per cent on the outstanding capital stock of the leased companies.

The stockholdings remained constant during the entire year 1917. All of the leases were made prior to 1917.

All of the above companies, except X, Y, Z Company, are operated as an integral part of the Pocahontas Railway Company.

QUESTION:

Should a consolidated excess profits tax return be filed for the taxable year 1917?

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ANSWER:

A consolidated excess profits tax return for 1917 and consolidated income and profits tax returns for subsequent years (if the leases are continued to be held by the Pocahontas Railway) should be filed by the Pocahontas Railway Company, including therein Companies A, B, C, D and E.

It will be noted that in this particular case stockholdings have been disregarded for the reason that leases of this character, extending over hundreds of years, for all intents and purposes amount to ownership, as the stockholders have no control over the companies as long as the leases are in force.

The amount of money paid each year in consideration of leases is in a great many cases paid directly to the stockholders by the lessee, and in other cases the money is paid to the lessor, who distributes it to stockholders. The stock of the leased companies is in substantially the same class as guaranteed non-voting stock.

PROBLEM 46

Propriety of Consolidation—Illustrating, Equitable Ownership

FACTS:

Stockholders	Co. 1	Co. 2	Co. 3	Co. 4
A	1%	20%	25%	
B	1%			25%
C	1%			25%
D	1%	20%	25%	
E	1%			25%
F	1%			25%
G		20%	25%	
H		20%		
I		20%	25%	
Sundry	94%			
	100%	100%	100%	100%

PROBLEMS

Company 1 is the equitable owner of the stock of Companies 2, 3 and 4. The stockholders, as shown above, are stockholders of record only.

The conditions obtained during the entire taxable year 1918.

QUESTION:

Is a consolidated income and profits tax return required for the taxable year 1918?

ANSWER:

Yes.

It is stated that Company 1 is the equitable owner of Companies 2, 3 and 4, and that the stockholders, as shown in the problem, are stockholders of record only.

What the Bureau is interested in is the equitable owner and not the stockholders of record.

Sometimes it happens that state laws prohibit one corporation from owning stock in another. Dummies are therefore used as stockholders.

In such cases, the stock is endorsed in blank and turned over to the equitable owner. Therefore, it will be seen that in such cases the equitable owner has entire control of the stock. As this is evidently true in this particular case, Companies 1, 2, 3 and 4 would file a consolidated income and profits tax return for the taxable year 1918.

REFERENCE:

Section 240, Revenue Act of 1918.

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PROBLEM 47

Propriety of Consolidation—Illustrating a Foreign Corporation as the Parent Corporation

FACTS:

Stockholders	Co. 1	Co. 2	Co. 3	Co. 4	Co. 5	Co. 6
Foreign Corp.	100%		100%	100%		
Domestic Corp. No. 1		100%			66%	100%
A					26%	
B					8%	
	<hr/> 100%	<hr/> 100%	<hr/> 100%	<hr/> 100%	<hr/> 100%	<hr/> 100%

Companies 1, 2, 3, 4, 5 and 6 are domestic corporations. There were no changes in stockholdings during the year 1918.

QUESTION:

Should a consolidated income and profits tax return be filed including therein each of these companies for the taxable year 1918?

ANSWER:

It will be noted that the foreign corporation owns 100 per cent of Companies 1, 3 and 4. However, under Section 240 of the Revenue Act of 1918, a foreign corporation is not allowed to be included in a consolidated return with domestic corporations, but inasmuch as the domestic corporations 1, 3 and 4 are owned by the same interest, they are required to file a consolidated income and profits tax return.

The problem states that domestic corporation 1 owns the entire capital stock of corporations 2 and 6. Therefore, these two corporations would also have to be included in the consolidated return with Companies 1, 3 and 4.

PROBLEMS

Companies 1, 3 and 4 would be grouped as a "brother and brother" relationship, while Companies 2 and 6 would be classed as "children" of Company 1, consequently we have a "brother and brother" and a "parent and child" consolidation.

Corporation 5 would be excluded from the consolidation as Company 1 owns only 66 per cent of its stock, while A and B, the minority interest, own the remaining 34 per cent. As this minority interest is not owned or controlled through closely affiliated interests, it does not come within the provisions of Section 240 of the Act.

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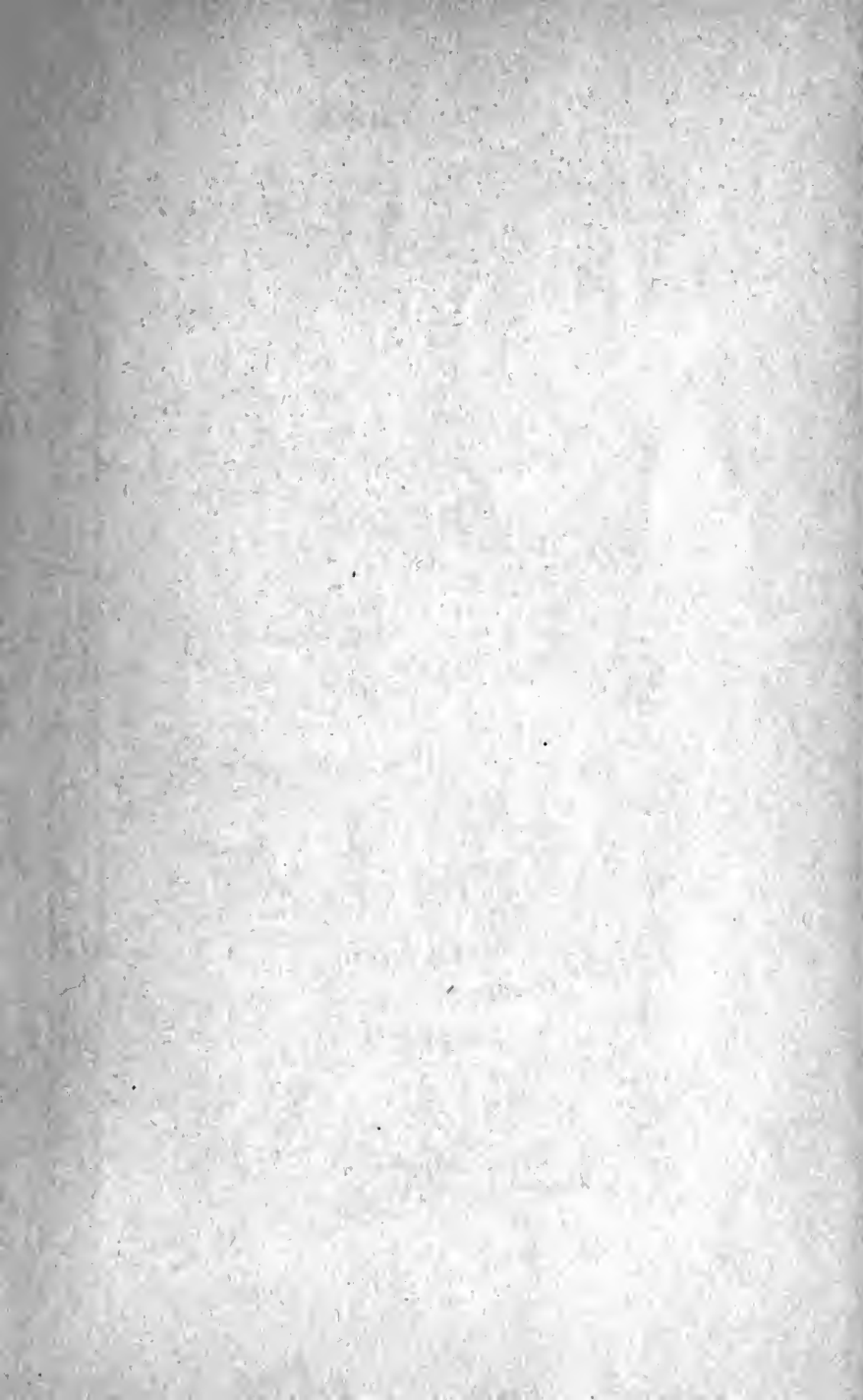
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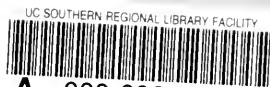


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